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Course #5180H/QAS5180H

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Corporate and Partnership Income Taxation (Course #5180H/QAS5180H)

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Section 1

Corporations

Chapter 1: Corporation General Tax Information

I. Introduction

This course discusses the general tax laws that apply to ordinary domestic corporations. It explains the tax law in plain language so it will be easier to understand. However, the information given does not cover every situation and is not intended to replace the law or change its meaning.

II. Business Taxed as a Corporation

The rules you must use to determine whether a business is taxed as a corporation changed for businesses formed after 1996.

Business formed before 1997. A business formed before 1997 and taxed as a corporation under the old rules will generally continue to be taxed as a corporation.

Business formed after 1996. The following businesses formed after 1996 are taxed as corporations.

- A business formed under a federal or state law that refers to it as a corporation, body corporate, or body politic.
- A business formed under a state law that refers to it as a joint-stock company or joint-stock association.
- An insurance company.
- Certain banks.
- A business wholly owned by a state or local government.
- A business specifically required to be taxed as a corporation by the Internal Revenue Code (for example, certain publicly traded partnerships).
- Certain foreign businesses.
- Any other business that elects to be taxed as a corporation by filing Form 8832. For more information, see the instructions for Form 8832.

III. Exchange of Property for Stock

If you transfer property (or money and property) to a corporation in exchange for stock in that corporation (other than nonqualified preferred stock, described later), and immediately afterward you are in control of the corporation, the exchange is usually not taxable. This rule applies both to individuals and to groups who transfer property to a corporation. It also applies whether the corporation is being formed or is already operating. It does not apply in the following situations.

- The corporation is an investment company.
- The property is transferred in a bankruptcy or similar proceeding in exchange for stock used to pay creditors.
- The stock is received in exchange for the corporation's debt (other than a security) or for interest on the corporation's debt (including a security) that accrued while you held the debt.

Tip. Both the corporation and any person involved in a nontaxable exchange of property for stock must attach to their income tax returns a complete statement of all facts pertinent to the exchange. For more information, see section 1.351-3 of the regulations.

Control of a corporation. To be in control of a corporation, you or your group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock of the corporation.

Example 1. You and Bill Jones buy property for \$100,000. You both organize a corporation when the property has a fair market value of \$300,000. You transfer the property to the corporation for all its authorized capital stock, which has a par value of \$300,000. No gain is recognized by you, Bill, or the corporation.

Example 2. You and Bill transfer the property with a basis of \$100,000 to a corporation in exchange for stock with a fair market value of \$300,000. This represents only 75% of each class of stock of the corporation. The other 25% was already issued to someone else. You and Bill recognize a taxable gain of \$200,000 on the transaction.

Services rendered. The term *property* does not include services rendered or to be rendered to the issuing corporation. The value of stock received for services is income to the recipient.

Example. You transfer property worth \$35,000 and render services valued at \$3,000 to a corporation in exchange for stock valued at \$38,000. Right after the exchange you own 85% of the outstanding stock. No gain is recognized on the exchange of property. However, you recognize ordinary income of \$3,000 as payment for services you rendered to the corporation.

Property of relatively small value. The term *property* does not include property of a relatively small value when it is compared to the value of stock and securities already owned or to be received for services by the transferor if the main purpose of the transfer is to qualify for the nonrecognition of gain or loss by other transferors.

Property transferred will not be considered to be of relatively small value if its fair market value is at least 10% of the fair market value of the stock and securities already owned or to be received for services by the transferor.

Stock received in disproportion to property transferred. If a group of transferors exchange property for corporate stock, each transferor does not have to receive stock in proportion to his or her interest in the property transferred. If a disproportionate transfer takes place, it will be treated for tax purposes in accordance with its true nature. It may be treated as if the stock were first received in proportion and then some of it used to make gifts, pay compensation for services, or satisfy the transferor's obligations.

Money or other property received. If, in an otherwise nontaxable exchange, you also receive money or property other than stock, you may have to recognize gain. You recognize gain only up to the amount of money plus the fair market value of the other property you receive. The rules for figuring the recognized gain in this situation generally follow those for a partially nontaxable exchange discussed in Publication 544 under *Like-Kind Exchanges*. If the property you exchange includes depreciable property, the recognized gain may have to be reported as ordinary income from depreciation. No loss is recognized.

Nonqualified preferred stock. Nonqualified preferred stock is treated as property other than stock. Therefore, there could be gain. Generally, it is preferred stock with any of the following features.

- The holder has the right to require the issuer or a related person to redeem or buy the stock.
- The issuer or a related person is required to redeem or buy the stock.
- The issuer or a related person has the right to redeem or buy the stock and, on the issue date, it is more likely than not that the right will be exercised.
- The dividend rate on the stock varies with reference to interest rates, commodity prices, or similar indices.

For a detailed definition of nonqualified preferred stock, see section 351(g)(2) of the Internal Revenue Code.

Liabilities. If the corporation assumes your liabilities, the exchange is generally not treated as if you received money or other property. There are two exceptions to this treatment.

- If the liabilities the corporation assumes are more than your adjusted basis in the property you transfer, gain is recognized up to the difference. However, if the liabilities assumed give rise to a deduction when paid, such as a trade account payable or interest, no gain is recognized.
- If there is no good business reason for the corporation to assume your liabilities, or if your main purpose in the exchange is to avoid federal income tax, the assumption is treated as if you received money in the amount of the liabilities.

For more information on the assumption of liabilities, see section 357(d) of the Internal Revenue Code.

Example. You transfer property to a corporation for stock. Immediately after the transfer you control the corporation. You also receive \$10,000 in the exchange. Your adjusted basis in the transferred property is \$20,000. The stock you receive has a fair market value of \$16,000. The corporation also assumes a \$5,000 mortgage on the property for which you are personally liable. Gain is recognized as follows.

Fair market value of stock received	\$16,000
Cash received	10,000
Liability assumed by corporation	<u>5,000</u>
Total received	\$31,000
Minus: Adjusted basis of property transferred	<u>20,000</u>
Realized gain	<u>\$11,000</u>

The liability assumed is not treated as money or other property. The recognized gain is limited to \$10,000, the cash received.

Loss on exchange. If you have a loss from an exchange and own, directly or indirectly, more than 50% of the corporation's stock, you cannot deduct the loss.

Basis of stock or other property received. The basis of the stock you receive is generally the adjusted basis of the property you transfer. Increase this amount by any amount treated as a dividend, plus any gain recognized on the exchange. Decrease this amount by any cash you received, the fair market value of any other property you received, and any loss recognized on the exchange. Also decrease this amount by the amount of any liability the corporation or another party to the exchange assumed from you, unless payment of the liability gives rise to a deduction when paid.

Further decreases may be required when the corporation or another party to the exchange assumes from you a liability that gives rise to a deduction when paid after October 18, 1999, if the basis of the stock would otherwise be higher than its fair market value on the date of the exchange. This rule does not apply if the entity assuming the liability acquired either substantially all of the assets or the trade or business with which the liability is associated.

The basis of any other property you receive is its fair market value on the date of the trade.

Basis of property transferred. A corporation that receives property from you in exchange for its stock generally has the same basis you had in the property, increased by any gain you recognized on the exchange. However, the increase for the gain recognized may be limited. For more information, see section 362 of the Internal Revenue Code.

IV. Capital Contributions

This section explains the tax treatment of contributions from shareholders and nonshareholders.

Paid-in capital. Contributions to the capital of a corporation, whether or not by shareholders, are paid-in capital. These contributions are not taxable to the corporation.

Basis. The corporation's basis of property contributed to capital by a shareholder is the same as the basis the shareholder had in the property, increased by any gain the shareholder recognized on the exchange. However, the increase for the gain recognized may be limited. For more information, see section 362 of the Internal Revenue Code.

The basis of property contributed to capital by a person other than a shareholder is zero.

If a corporation receives a cash contribution from a person other than a shareholder, the corporation must reduce the basis of any property acquired with the contribution during the 12-month period beginning on the day it received the contribution by the amount of the contribution. If the amount contributed is more than the cost of the property acquired, then reduce, but not below zero, the basis of the other properties held by the corporation on the last day of the 12-month period in the following order.

1. Depreciable property.
2. Amortizable property.
3. Property subject to cost depletion but not to percentage depletion.
4. All other remaining properties.

Reduce the basis of property in each category to zero before going on to the next category.

There may be more than one piece of property in each category. Base the reduction of the basis of each property on the ratio of the basis of each piece of property to the total bases of all property in that category. If the corporation wishes to make this adjustment in some other way, it must get IRS approval. The corporation files a request for approval with its income tax return for the tax year in which it receives the contribution.

V. Paying and Filing Income Taxes

The federal income tax is a pay-as-you-go tax. A corporation generally must make estimated tax payments as it earns or receives income during its tax year. After the end of the year, the corporation must file an income tax return. This section will help you determine when and how to pay and file corporate income taxes.

INCOME TAX RETURN

This section will help you determine when and how to report a corporation's income tax.

Who must file. Unless exempt under section 501 of the Internal Revenue Code, all domestic corporations in existence for any part of a taxable year (including corporations in bankruptcy) must file an income tax return whether or not they have taxable income.

Which form to file. A corporation must generally file *Form 1120* to report its income, gains, losses, deductions, credits, and to figure its income tax liability. Certain organizations must file special returns. For more information, see the instructions for Forms 1120.

When to file. Generally, a corporation must file its income tax return by the 15th day of the 3rd month after the end of its tax year. A new corporation filing a short-period return must generally file by the 15th day of the 3rd month after the short period ends. A corporation that has dissolved must generally file by the 15th day of the 3rd month after the date it dissolved.

Example 1. A corporation's tax year ends December 31. It must file its income tax return by March 15th.

Example 2. A corporation's tax year ends June 30. It must file its income tax return by September 15th.

If the due date falls on a Saturday, Sunday, or legal holiday, the due date is extended to the next business day.

Extension of time to file. File *Form 7004* to request a 6-month extension of time to file a corporation income tax return. The IRS will grant the extension if you complete the form properly, file it, and pay any tax due by the original due date for the return.

Form 7004 does not extend the time for paying the tax due on the return. Interest, and possibly penalties, will be charged on any part of the final tax due not shown as a balance due on Form 7004. The interest is figured from the original due date of the return to the date of payment.

For more information, see the instructions for Form 7004.

Penalties

Late filing of return. A corporation that does not file its tax return by the due date, including extensions, may be penalized 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax. If the corporation is charged a penalty for late payment of tax (discussed next) for the same period of time, the penalty for late filing is reduced by the amount of the penalty for late payment. The minimum penalty for a return that is over 60 days late is the smaller of the tax due or \$100. The penalty will not be imposed if the corporation can show the failure to file on time was due to a reasonable cause. Corporations that have a reasonable cause to file late must attach a statement explaining the reasonable cause.

Late payment of tax. A corporation that does not pay the tax when due may be penalized 1/2 of 1% of the unpaid tax for each month or part of a month the tax is not paid, up to a maximum of 25% of the unpaid tax. The penalty will not be imposed if the corporation can show that the failure to pay on time was due to a reasonable cause.

Trust fund recovery penalty. If income, social security, and Medicare taxes that a corporation must withhold from employee wages are not withheld or are not deposited or paid to the United States Treasury, the trust fund recovery penalty may apply. The penalty is the full amount of the unpaid trust fund tax. This penalty may apply to you if these unpaid taxes cannot be immediately collected from the business.

The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to be responsible for collecting, accounting for, and paying these taxes, and who acted willfully in not doing so.

A **responsible person** can be an officer or employee of a corporation, an accountant, or a volunteer director/trustee. A responsible person also may include one who signs checks for the corporation or otherwise has authority to cause the spending of business funds.

Willfully means voluntarily, consciously, and intentionally. A responsible person acts willfully if the person knows the required actions are not taking place.

ESTIMATED TAX

Generally, a corporation must make installment payments if it expects its estimated tax for the year to be \$500 or more. If the corporation does not pay the installments when they are due, it could be subject to an underpayment penalty. This section will explain how to avoid this penalty.

When to pay estimated tax. Installment payments are due by the 15th day of the 4th, 6th, 9th, and 12th months of the corporation's tax year.

Example 1. Your corporation's tax year ends December 31. Installment payments are due on April 15, June 15, September 15, and December 15.

Example 2. Your corporation's tax year ends June 30. Installment payments are due on October 15, December 15, March 15, and June 15.

If any due date falls on a Saturday, Sunday, or legal holiday, the installment is due on the next business day.

How to figure each required installment. Use *Form 1120-W* to figure each required installment of estimated tax. You will generally use one of the following two methods to figure each required installment. You should use the method that yields the smallest installment payments.

Note: In these discussions, "return" generally refers to the corporation's original return. However, an amended return is considered the original return if it is filed by the due date (including extensions) of the original return.

Method 1. Each required installment is 25% of the income tax the corporation will show on its return for the current year.

Method 2. Each required installment is 25% of the income tax shown on the corporation's return for the previous year. To use *Method 2*:

1. The corporation must have filed a return for the previous year,
2. The return must have been for a full 12 months, and
3. The return must have shown a positive tax liability (not zero).

Also, if the corporation is a large corporation, it can use Method 2 to figure the first installment only.

A large corporation is one with at least \$1 million of modified taxable income in any of the last 3 years. Modified taxable income is taxable income figured without net operating loss or capital loss carrybacks or carryovers.

Other methods. If a corporation's income is expected to vary during the year because, for example, its business is seasonal, it may be able to lower the amount of one or more required installments by using one or both of the following methods.

1. The annualized income installment method.
2. The adjusted seasonal installment method.

Use Schedule A of Form 1120-W to see if using one or both of these methods will lower the amount of any required installments.

Refiguring required installments. If after the corporation figures and deposits its estimated tax it finds that its tax liability for the year will be more or less than originally estimated, it may have to refigure its required installments to see if an underpayment penalty may apply. An immediate catchup payment should be made to reduce any penalty resulting from the underpayment of any earlier installments.

Underpayment penalty. If the corporation does not pay a required installment of estimated tax by its due date, it may be subject to a penalty. The penalty is figured separately for each installment due date. The corporation may owe a penalty for an earlier due date, even if it paid enough tax later to make up the underpayment. This is true even if the corporation is due a refund when its return is filed.

Form 2220. Use Form 2220 to determine if a corporation is subject to the penalty for underpayment of estimated tax and, if so, the amount of the penalty.

If the corporation is charged a penalty, the amount of the penalty depends on the following three factors.

1. The amount of the underpayment.
2. The period during which the underpayment was due and unpaid.
3. The interest rate for underpayments published quarterly by the IRS in the Internal Revenue Bulletin.

A corporation generally does not have to file Form 2220 with its income tax return because the IRS will figure any penalty and bill the corporation. However, even if the corporation does not owe a penalty, complete and attach the form to the corporation's tax return if any of the following apply.

1. The annualized income installment method was used to figure any required installment.
2. The adjusted seasonal installment method was used to figure any required installment.
3. The corporation is a large corporation figuring its first required installment based on the prior year's tax.

How to pay estimated tax. If the corporation is required to use EFTPS to pay its taxes, it must also use EFTPS to make its estimated tax deposits. If the corporation does not use EFTPS, it should make its estimated tax deposits with an authorized financial institution using Form 8109.

Quick refund of overpayments. A corporation that has overpaid its estimated tax for the tax year may be able to apply for a quick refund. Use *Form 4466* to apply for a quick refund of an overpayment of estimated tax. A corporation can apply for a quick refund if the overpayment is:

- At least 10% of its expected tax liability, *and*
- At least \$500.

Use Form 4466 to figure the corporation's expected tax liability and the overpayment of estimated tax.

File Form 4466 before the 16th day of the 3rd month after the end of the tax year, but *before* the corporation files its income tax return. Do not file Form 4466 before the end of the corporation's tax year. An extension of time to file the corporation's income tax return will not extend the time for filing Form 4466. The IRS will act on the form within 45 days from the date you file it.

U.S. REAL PROPERTY INTEREST

If a domestic corporation acquires a U.S. real property interest from a foreign person or firm, the corporation may have to withhold tax on the amount it pays for the property. The amount paid includes cash, the fair market value of other property, and any assumed liability. If a domestic corporation distributes a U.S. real property interest to a foreign person or firm, it may have to withhold tax on the fair market value of the property. A corporation that fails to withhold may be liable for the tax, and any penalties and interest that apply.

VI. Income, Deductions, and Special Provisions

Rules on income and deductions that apply to individuals also apply, for the most part, to corporations. However, some of the following special provisions apply only to corporations.

COSTS OF GOING INTO BUSINESS

When you go into business, treat all costs you incur to get your business started as capital expenses. See *Capital Expenses* in chapter 1 of Publication 535 for a discussion of how to treat these costs if you do not go into business.

However, a corporation can elect to deduct a limited amount of start-up or organizational costs. Any cost not deducted can be amortized.

Start-up costs are costs for creating an active trade or business or investigating the creation or acquisition of an active trade or business. Organizational costs are the direct costs of creating the corporation.

For more information on deducting or amortizing start-up and organizational costs, see the Instructions for Form 1120 and chapters 8 and 9 of Publication 535.

RELATED PERSONS

A corporation that uses an accrual method of accounting cannot deduct business expenses and interest owed to a related person who uses the cash method of accounting *until* the corporation makes the payment and the corresponding amount is includible in the related person's gross income. Determine the relationship, for this rule, as of the end of the tax year for which the expense or interest would otherwise be deductible. If a deduction is denied under this rule, the rule will continue to apply even if the corporation's relationship with the person ends before the expense or interest is includible in the gross income of that person. These rules also deny the deduction of losses on the sale or exchange of property between related persons.

Related persons. For purposes of this rule, the following persons are related to a corporation.

1. Another corporation that is a member of the same controlled group as defined in section 267(f) of the Internal Revenue Code.
2. An individual who owns, directly or indirectly, more than 50% of the value of the outstanding stock of the corporation.

3. A trust fiduciary when the trust or the grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.
4. An S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.
5. A partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital or profits interest in the partnership.
6. Any employee-owner if the corporation is a personal service corporation (defined later), regardless of the amount of stock owned by the employee-owner.

Ownership of stock. To determine whether an individual directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply.

1. Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries.
2. An individual is treated as owning the stock owned, directly or indirectly, by or for his or her family. Family includes only brothers and sisters (including half brothers and half sisters), a spouse, ancestors, and lineal descendants.
3. Any individual owning (other than by applying rule (2)) any stock in a corporation is treated as owning the stock owned directly or indirectly by that individual's partner.
4. To apply rule (1), (2), or (3), stock constructively owned by a person under rule (1) is treated as actually owned by that person. But stock constructively owned by an individual under rule (2) or (3) is not treated as actually owned by the individual for applying either rule (2) or (3) to make another person the constructive owner of that stock.

Reallocation of income and deductions. Where it is necessary to clearly show income or prevent tax evasion, the IRS can reallocate gross income, deductions, credits, or allowances between two or more organizations, trades, or businesses owned or controlled directly, or indirectly, by the same interests.

Complete liquidations. The disallowance of losses from the sale or exchange of property between related persons does not apply to liquidating distributions.

INCOME FROM QUALIFYING SHIPPING ACTIVITIES

A corporation may make an election to be taxed on its notional shipping income at the highest corporate tax rate. If a corporation makes this election it may exclude income from qualifying shipping activities from gross income. Also if the election is made, the corporation generally may not claim any loss, deduction, or credit with respect to qualifying shipping activities. A corporation making this election may also elect to defer gain on the disposition of a qualifying vessel.

A corporation uses Form 8902, Alternative Tax on Qualifying Shipping Activities, to make the election and figure the alternative tax. For more information regarding the election, see Form 8902.

ELECTION TO EXPENSE QUALIFIED REFINERY PROPERTY

A corporation can make an irrevocable election on its tax return filed by the due date (including extensions) to deduct 50% of the cost of qualified refinery property (defined in section 179C(c) of the Internal Revenue Code), placed into service after August 8, 2005, and before January 1, 2012. The deduction is allowed the year the property is placed in service.

A subchapter T cooperative can make an irrevocable election on its return by the due date (including extensions) to allocate this deduction to its owners based on their ownership interest.

For more information see section 179C of the Internal Revenue Code.

DEDUCTION TO COMPLY WITH EPA SULFUR REGULATIONS

A small business refiner can make an irrevocable election on its tax return filed by the due date (including extensions) to deduct up to 75% of qualified costs paid or incurred to comply with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency (EPA).

A subchapter T cooperative can make an irrevocable election on its return filed by the due date (including extensions) to allocate the deduction to its owners based on their ownership interest.

For more information, see sections 45H and 179B of the Internal Revenue Code.

ENERGY-EFFICIENT COMMERCIAL BUILDING PROPERTY DEDUCTION

A corporation can claim a deduction for costs associated with energy-efficient commercial building property, placed in service after December 31, 2005, and before January 1, 2008. In order to qualify for the deduction:

- The costs must be associated with depreciable or amortizable property in a Standard 90.1-2001 domestic building;
- The property must be either a part of the interior lighting system, the heating, cooling, ventilation and hot water system, or the building envelope (defined in section 179D(c)(1)(C) of the Internal Revenue Code); and
- The property must be installed as part of a plan to reduce the total annual energy and power costs of the building by 50%.

The deduction is limited to \$1.80 per square foot of the building less the total amount of deductions taken for this property in prior tax years. The corporation must reduce the basis of any property by any deduction taken. The deduction is subject to recapture if the corporation fails to fully implement an energy savings plan.

For more information see section 179D of the Internal Revenue Code.

The Emergency Economic Stabilization Act of 2008, approved and signed on October 3, 2008, extends the benefits of the Energy Policy Act of 2005 through December 31, 2013.

CORPORATE PREFERENCE ITEMS

A corporation must make special adjustments to certain items before it takes them into account in determining its taxable income. These items are known as corporate preference items and they include the following.

- Gain on the disposition of section 1250 property.
- Percentage depletion for iron ore and coal (including lignite).
- Amortization of pollution control facilities.
- Mineral exploration and development costs.

For more information on corporate preference items, see section 291 of the Internal Revenue Code.

DIVIDENDS-RECEIVED DEDUCTION

A corporation can deduct a percentage of certain dividends received during its tax year. This section discusses the general rules that apply. For more information, see the instructions for Form 1120.

Dividends from domestic corporations. A corporation can deduct, within certain limits, 70% of the dividends received if the corporation receiving the dividend owns *less than 20%* of the corporation distributing the dividend. If the corporation owns 20% or *more* of the distributing corporation's stock, it can, subject to certain limits, deduct 80% of the dividends received.

Ownership. Determine ownership, for these rules, by the amount of voting power and value of the paying corporation's stock (other than certain preferred stock) the receiving corporation owns.

Small business investment companies. Small business investment companies can deduct 100% of the dividends received from taxable domestic corporations.

Dividends from regulated investment companies. Regulated investment company dividends received are subject to certain limits. Capital gain dividends received from a regulated investment company do not qualify for the deduction.

Dividends from a controlled foreign corporation. A corporation can make a one-time election to deduct 85% of the dividends received from a controlled foreign corporation. The corporation may make the election for either its last tax year that begins before October 22, 2004, or its first tax year that begins during the one-year period beginning on October 22, 2004. The corporation makes the election by completing and attaching Form 8895, One-Time Dividends Received Deduction for Certain Cash Dividends from Controlled Foreign Corporations, to its return by the due date (including extensions). This deduction only applies to dividends included in gross income. For more information on making this election and figuring the deduction, see Form 8895.

No deduction allowed for certain dividends. Corporations cannot take a deduction for dividends received from the following entities.

1. A real estate investment trust (REIT).
2. A corporation exempt from tax under section 501 or 521 of the Internal Revenue Code either for the tax year of the distribution or the preceding tax year.
3. A corporation whose stock was held less than 46 days during the 90-day period beginning 45 days before the stock became ex-dividend with respect to the dividend. Ex-dividend means the holder has no *rights* to the dividend.
4. A corporation whose preferred stock was held less than 91 days during the 180-day period beginning 90 days before the stock became ex-dividend with respect to the dividend if the dividends received are for a period or periods totaling more than 360 days.
5. Any corporation, if your corporation is under an obligation (pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Dividends on deposits. Dividends on deposits or withdrawable accounts in domestic building and loan associations, mutual savings banks, cooperative banks, and similar organizations are interest, not dividends. They do not qualify for this deduction.

Limit on deduction for dividends. The total deduction for dividends received or accrued is generally limited (in the following order) to:

1. 80% of the difference between taxable income and the 100% deduction allowed for dividends received from affiliated corporations, or by a small business investment company, for dividends received or accrued from 20%-owned corporations, then
2. 70% of the difference between taxable income and the 100% deduction allowed for dividends received from affiliated corporations, or by a small business investment company, for dividends received or accrued from less-than-20%-owned corporations (reducing taxable income by the total dividends received from 20%-owned corporations).

Figuring the limit. In figuring the limit, determine taxable income without the following items.

1. The net operating loss deduction.
2. The domestic production activities deduction.
3. The deduction for dividends received.
4. Any adjustment due to the nontaxable part of an extraordinary dividend (see *Extraordinary Dividends*, later).
5. Any capital loss carryback to the tax year.

Effect of net operating loss. If a corporation has a net operating loss (NOL) for a tax year, the limit of 80% (or 70%) of taxable income does not apply. To determine whether a corporation has an NOL, figure the dividends-received deduction without the 80% (or 70%) of taxable income limit.

Example 1. A corporation loses \$25,000 from operations. It receives \$100,000 in dividends from a 20%-owned corporation. Its taxable income is \$75,000 (\$100,000 - \$25,000) before the deduction for dividends received. If it claims the full dividends-received deduction of \$80,000 (\$100,000 X 80%) and combines it with an operations loss of \$25,000, it will have an NOL of (\$5,000). Therefore, the 80% of taxable income limit does not apply. The corporation can deduct the full \$80,000.

Example 2. Assume the same facts as in Example 1, except that the corporation only loses \$15,000 from operations. Its taxable income is \$85,000 before the deduction for dividends received. After claiming the dividends-received deduction of \$80,000 (\$100,000 X 80%), its taxable income is \$5,000. Because the corporation will not have an NOL after applying a full dividends-received deduction, its allowable dividends-received deduction is limited to 80% of its taxable income, or \$68,000 (\$85,000 X 80%).

EXTRAORDINARY DIVIDENDS

If a corporation receives an extraordinary dividend on stock held 2 years or less before the dividend announcement date, it generally must reduce its basis in the stock by the nontaxed part of the dividend. The nontaxed part is any dividends-received deduction allowable for the dividends.

Extraordinary dividend. An extraordinary dividend is any dividend on stock that equals or exceeds a certain percentage of the corporation's adjusted basis in the stock. The percentages are:

1. 5% for stock preferred as to dividends, or
2. 10% for other stock.

Treat all dividends received that have ex-dividend dates within an 85-consecutive-day period as one dividend. Treat all dividends received that have ex-dividend dates within a 365-consecutive-day period as extraordinary dividends if the total of the dividends exceeds 20% of the corporation's adjusted basis in the stock.

Disqualified preferred stock. Any dividend on disqualified preferred stock is treated as an extraordinary dividend regardless of the period of time the corporation held the stock.

Disqualified preferred stock is any stock preferred as to dividends if any of the following apply.

1. The stock when issued has a dividend rate that declines (or can reasonably be expected to decline) in the future.
2. The issue price of the stock exceeds its liquidation rights or stated redemption price.
3. The stock is otherwise structured to avoid the rules for extraordinary dividends and to enable corporate shareholders to reduce tax through a combination of dividends-received deductions and loss on the disposition of the stock.

These rules apply to stock issued after July 10, 1989, unless it was issued under a written binding contract in effect on that date, and thereafter, before the issuance of the stock.

More information. For more information on extraordinary dividends, see section 1059 of the Internal Revenue Code.

BELOW-MARKET LOANS

A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. A below-market loan generally is treated as an arm's-length transaction in which the borrower is considered as having received both the following:

- A loan in exchange for a note that requires payment of interest at the applicable federal rate, and
- An additional payment in an amount equal to the foregone interest.

Treat the additional payment as a gift, dividend, contribution to capital, payment of compensation, or other payment, depending on the substance of the transaction.

Foregone interest. For any period, foregone interest is equal to:

1. The interest that would be payable for that period if interest accrued on the loan at the applicable federal rate and was payable annually on December 31, minus
2. Any interest actually payable on the loan for the period.

CHARITABLE CONTRIBUTIONS

A corporation can claim a limited deduction for charitable contributions made in cash or other property. The contribution is deductible if made to, or for the use of, a qualified organization. For more information on qualified organizations, see Publication 526, *Charitable Contributions*, and Publication 78, *Cumulative List of Organizations*.

Note: You cannot take a deduction if any of the net earnings of an organization receiving contributions benefit any private shareholder or individual.

Cash method corporation. A corporation using the cash method of accounting deducts contributions in the tax year paid.

Accrual method corporation. A corporation using an accrual method of accounting can choose to deduct unpaid contributions for the tax year the board of directors authorizes them if it pays them by the 15th day of the 3rd month after the close of that tax year. Make the choice by reporting the contribution on the corporation's return for the tax year. A copy of the resolution authorizing the contribution and a declaration stating that the board of directors adopted the resolution during the tax year must accompany the return. The declaration must include the date the resolution was adopted.

Limitations on deduction. A corporation cannot deduct charitable contributions that exceed 10% of its taxable income for the tax year. Figure taxable income for this purpose without the following.

1. The deduction for charitable contributions.
2. The dividends-received deduction.
3. The deduction allowed under section 249 of the Internal Revenue Code.
4. The domestic production activities deduction.
5. Any net operating loss carryback to the tax year.
6. Any capital loss carryback to the tax year.

Carryover of excess contributions. You can carry over, within certain limits, to each of the subsequent five years any charitable contributions made during the current year that exceed the 10% limit. You lose any excess not used within that period. For example, if a corporation has a carryover of excess contributions paid in 2006 and it does not use all the excess on its return for 2007, it can carry the rest over to 2008, 2009, 2010, and 2011. Do not deduct a carryover of excess contributions in the carryover year until after you deduct contributions made in that year (subject to the 10% limit). You cannot deduct a carryover of excess contributions to the extent it increases a net operating loss carryover.

Substantiation requirements. Generally, no deduction is allowed for any contribution of \$250 or more unless the corporation gets a written acknowledgement from the donee organization. The acknowledgement should show the amount of cash contributed, a description of the property contributed, and either gives a description and a good faith estimate of the value of any goods or services provided in return for the contribution or states that no goods or services were provided in return for the contribution. The acknowledgement should be received by the due date (including extensions) of the return, or, if earlier, the date the return was filed. Keep the acknowledgement with other corporate records. Do not attach the acknowledgement to the return.

Contributions of property other than cash. If a corporation (other than a closely-held or a personal service corporation) claims a deduction of more than \$500 for contributions of property other than cash, a schedule describing the property and the method used to determine its fair market value must be attached to the corporation's return. In addition the corporation should keep a record of:

- The approximate date and manner of acquisition of the donated property and
- The cost or other basis of the donated property held by the donor for less than 12 months prior to contribution.

Closely held and personal service corporations must complete and attach Form 8283, Noncash Charitable Contributions, to their returns if they claim a deduction of more than \$500 for non-cash contributions. For all other corporations, if the deduction claimed for donated property exceeds \$5,000, complete Form 8283 and attach it to the corporation's return.

A corporation must obtain a qualified appraisal for all deductions of property claimed in excess of \$5,000. A qualified appraisal is not required for the donation of cash, publicly traded securities, inventory, and any qualified vehicles sold by a donee organization without any significant intervening use or material improvement. The appraisal should be maintained with other corporate records and only attached to the corporation's return when the deduction claimed exceeds \$500,000; \$20,000 for donated art work.

See Form 8283 for more information.

Qualified conservation contributions. If a corporation makes a qualified conservation contribution, the corporation must provide information regarding the legal interest being donated, the fair market value of the underlying property before and after the donation, and a description of the conservation purpose for which the property will be used. For more information, see section 170(h) of the Internal Revenue Code.

Contributions of used vehicles. A corporation is allowed a deduction for the contribution of used motor vehicles, boats, and airplanes. The deduction is limited to the gross proceeds from the sale of the vehicle, if it is sold without any intervening use or material improvement by the donee organization. An acknowledgement from the donee organization for deductions claimed in excess of \$500 must be attached to the corporation's return. The acknowledgement must include the vehicle identification number or similar number, gross proceeds from the sale of the vehicle, and a statement that the deductible amount cannot exceed the gross proceeds from the sale. For more information, see Publication 526.

Reduction for contributions of certain property. For a charitable contribution of property, the corporation must reduce the contribution by the sum of:

- The ordinary income and short-term capital gain that would have resulted if the property were sold at its FMV and
- For certain contributions, the long-term capital gain that would have resulted if the property were sold at its FMV.

The reduction for the long-term capital gain applies to:

- Contributions of tangible personal property for use by an exempt organization for a purpose or function unrelated to the basis for its exemption;
- Contributions of any property to or for the use of certain private foundations except for stock for which market quotations are readily available; and
- Contributions of any patent, certain copyrights, trademark, trade name, trade secret, know-how, software (that is a section 197 intangible), or similar property, or applications or registrations of such property.

Larger deduction. A corporation (other than an S corporation) may be able to claim a deduction equal to the lesser of (a) the basis of the donated inventory or property plus one-half of the inventory or property's appreciation (gain if the donated inventory or property was sold at fair market value on the date of the donation), or (b) two times basis of the donated inventory or property. This deduction may be allowed for certain contributions of:

- Inventory and other property made to a donee organization and used solely for the care of the ill, the needy, and infants.
- Scientific property constructed by the corporation (other than an S corporation, personal holding company, or personal service corporation) and donated no later than 2 years after substantial completion of the construction. The property must be donated to a qualified organization and its original use must be by the donee for research, experimentation, or research training within the United States in the area of physical or biological science.

- Computer technology and equipment acquired or constructed and donated no later than 3 years after either acquisition or substantial completion of construction to an educational organization for educational purposes within the United States.

Contributions to organizations conducting lobbying activities. Contributions made to an organization that conducts lobbying activities are not deductible if:

- The lobbying activities relate to matters of direct financial interest to the donor's trade or business and
- The principal purpose of the contribution was to avoid federal income tax by obtaining a deduction for activities that would have been nondeductible under the lobbying expense rules if conducted directly by the donor.

More information. For more information on charitable contributions, including substantiation and recordkeeping requirements, see section 170 of the Internal Revenue Code, the related regulations, and Publication 526.

CAPITAL LOSSES

A corporation can deduct capital losses only up to the amount of its capital gains. In other words, if a corporation has an excess capital loss, it cannot deduct the loss in the current tax year. Instead, it carries the loss to other tax years and deducts it from capital gains that occur in those years.

A capital loss is carried to other years in the following order.

1. 3 years prior to the loss year.
2. 2 years prior to the loss year.
3. 1 year prior to the loss year.
4. Any loss remaining is carried forward for 5 years.

When you carry a net capital loss to another tax year, treat it as a short-term loss. It does not retain its original identity as long term or short term.

Example. A calendar year corporation has a net short-term capital gain of \$3,000 and a net long-term capital loss of \$9,000. The short-term gain offsets some of the long-term loss, leaving a net capital loss of \$6,000. The corporation treats this \$6,000 as a short-term loss when carried back or forward.

The corporation carries the \$6,000 short-term loss back 3 years. In Year 1, the corporation had a net short-term capital gain of \$8,000 and a net long-term capital gain of \$5,000. It subtracts the \$6,000 short-term loss first from the net short-term gain. This results in a net capital gain for Year 1 of \$7,000. This consists of a net short-term capital gain of \$2,000 ($\$8,000 - \$6,000$) and a net long-term capital gain of \$5,000.

S corporation status. A corporation may not carry a capital loss from, or to, a year for which it is an S corporation.

Rules for carryover and carryback. When carrying a capital loss from one year to another, the following rules apply.

- When figuring the current year's net capital loss, you cannot combine it with a capital loss carried from another year. In other words, you can carry capital losses only to years that would otherwise have a total net capital gain.
- If you carry capital losses from 2 or more years to the same year, deduct the loss from the earliest year first.
- You cannot use a capital loss carried from another year to produce or increase a net operating loss in the year to which you carry it back.

Refunds. When you carry back a capital loss to an earlier tax year, refigure your tax for that year. If your corrected tax is less than the tax you originally owed, use either *Form 1139* or *Form 1120X* to apply for a refund.

Form 1139. A corporation can get a refund faster by using Form 1139. It cannot file Form 1139 before filing the return for the corporation's capital loss year, but it must file Form 1139 no later than one year after the year it sustains the capital loss.

Form 1120X. If the corporation does not file Form 1139, it must file Form 1120X to apply for a refund. The corporation must file the Form 1120X within 3 years of the due date, including extensions, for filing the return for the year in which it sustains the capital loss.

NET OPERATING LOSSES

A corporation generally figures and deducts a net operating loss (NOL) the same way an individual, estate, or trust does. The same 2-year carryback and up to 20-year carryforward periods apply, and the same sequence applies when the corporation carries two or more NOLs to the same year.

A corporation's NOL generally differs from individual, estate and trust NOLs in the following ways.

1. A corporation can take different deductions when figuring an NOL.
2. A corporation must make different modifications to its taxable income in the carryback or carryforward year when figuring how much of the NOL is used and how much is carried over to the next year.
3. A corporation also uses different forms when claiming an NOL deduction.

Note: With the passage of the Worker, Homeownership, and Business Assistance Act (WHBAA) of 2009, any business can elect to carryback an eligible NOL for up to five years (3, 4, or 5 years). NOL arising in any one taxable year ending after December 31, 2007 and beginning before January 1, 2010 can be elected. Small businesses that elected to carryback a 2008 NOL under the American Recovery and Reinvestment Act of 2009 provisions, however, can elect to carryback both the 2008 and 2009 NOL for the applicable five-year period. The WHBAA also suspends the 90 percent limitation on use

of net operating losses for AMT purposes in the case of a 2008 or 2009 NOL with respect to which an election to use the extended carryback period is made.

The following discussions explain these differences.

Figuring the NOL

A corporation figures an NOL in the same way it figures taxable income. It starts with its gross income and subtracts its deductions. If its deductions are more than its gross income, the corporation has an NOL.

However, the following rules for figuring the NOL apply.

1. A corporation cannot increase its current year NOL by carrybacks or carryovers from other years.
2. A corporation cannot use the domestic production activities deduction to create or increase its current year NOL, including any carryback or carryover.
3. A corporation can take the deduction for dividends received, explained later, without regard to the aggregate limits (based on taxable income) that normally apply.
4. A corporation can figure the deduction for dividends paid on certain preferred stock of public utilities without limiting it to its taxable income for the year.

Dividends-received deduction. The corporation's deduction for dividends received from domestic corporations is generally subject to an aggregate limit of 70% or 80% of taxable income. However, if a corporation sustains an NOL for a tax year, the limit based on taxable income does not apply. In determining if a corporation has an NOL, the corporation figures the dividends-received deduction without regard to the 70% or 80% of taxable income limit.

See *Dividends-Received Deduction* under *Income, Deductions, and Special Provisions*, earlier, for an example.

Claiming the NOL Deduction

Generally, a corporation must carry an NOL back 2 years prior to the year the NOL is generated. If the NOL is not used in the prior 2 years the remaining NOL can be carried forward for up to 20 years after the tax year in which the NOL was generated.

A corporation can make an election to waive the 2 year carryback period and use only the 20 year carryforward period. To make the election attach a statement to the original return filed by the due date (including extensions) for the NOL year.

Note: See note earlier for temporary NOL carryback extensions.

NOL carryback. The following rules apply.

- If a corporation carries back the NOL, it can use either Form 1120X or Form 1139. A corporation can get a refund faster by using Form 1139. It cannot file Form 1139 before filing the return for the corporation's NOL year, but it must file Form 1139 no later than 1 year after the year it sustains the NOL.

- If the corporation does not file Form 1139, it must file Form 1120X within 3 years of the due date, plus extensions, for filing the return for the year in which it sustains the NOL.
- A personal service corporation may not carryback an NOL to or from any tax year in which a section 444 election to have a tax year other than a required tax year applies.
- Certain electric utility companies may elect a 5 year carryback period for NOLs arising in tax years 2003, 2004, and 2005. The NOL carryback amount is limited to 20% of the total capital expenditures for electric transmission property and pollution control facilities. The election may be made during any tax year ending after December 31, 2005, and before January 1, 2009.
- A corporation can elect to treat a casualty loss arising in tax years ending after August 27, 2005, from the loss of public utility property used predominantly in a rate-regulated trade or business as a specified liability loss treated as a separate NOL subject to a 10 year carryback period. The loss must be the result of Hurricane Katrina. For more information see the Instructions for Form 1139.

NOL carryforward. If a corporation carries forward its NOL, it enters the carryover on Schedule K, Form 1120, line 12. It also enters the deduction for the carryover (but not more than the corporation's taxable income after special deductions) on line 29(a) of Form 1120.

Carryback expected. If a corporation expects to have an NOL in its current year, it can automatically extend the time for paying all or part of its income tax for the immediately preceding year. It does this by filing Form 1138. It must explain on the form why it expects the loss.

The payment of tax that may be postponed cannot exceed the expected overpayment from the carryback of the NOL.

Period of extension. The extension is in effect until the end of the month in which the return for the NOL year is due (including extensions).

If the corporation files Form 1139 before this date, the extension will continue until the date the IRS notifies the corporation that its Form 1139 is allowed or disallowed in whole or in part.

Figuring the NOL Carryover

If the NOL available for a carryback or carryforward year is greater than the taxable income for that year, the corporation must modify its taxable income to figure how much of the NOL it will use up in that year and how much it can carry over to the next tax year.

Its carryover is the excess of the available NOL over its modified taxable income for the carryback or carryforward year.

Modified taxable income. A corporation figures its modified taxable income the same way it figures its taxable income, with the following exceptions.

- It can deduct NOLs only from years *before* the NOL year whose carryover is being figured.
- The corporation must figure its deduction for charitable contributions without considering any NOL carrybacks.

The modified taxable income for any year cannot be less than zero.

Modified taxable income is used only to figure how much of an NOL the corporation uses up in the carryback or carryforward year and how much it carries to the next year. It is not used to fill out the corporation's tax return or figure its tax.

Ownership change. A loss corporation (one with cumulative losses) that has an ownership change is limited on the taxable income it can offset by NOL carryforwards arising before the date of the ownership change. This limit applies to any year ending after the change of ownership.

See sections 381 through 384, and 269 of the Internal Revenue Code and the related regulations for more information about the limits on corporate NOL carryovers and corporate ownership changes.

AT-RISK LIMITS

The at-risk rules limit your losses from most activities to your amount at risk in the activity. The at-risk limits apply to certain closely held corporations (other than S corporations).

The amount at risk generally equals:

- The money and the adjusted basis of property contributed by the taxpayer to the activity, and
- The money borrowed for the activity.

Closely held corporation. For the at-risk rules, a corporation is a closely held corporation if, at any time during the last half of the tax year, more than 50% in value of its outstanding stock is owned directly or indirectly by, or for, five or fewer individuals.

To figure if more than 50% in value of the stock is owned by five or fewer individuals, apply the following rules.

1. Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered owned proportionately by its shareholders, partners, or beneficiaries.
2. An individual is considered to own the stock owned, directly or indirectly, by or for his or her family. Family includes only brothers and sisters (including half brothers and half sisters), a spouse, ancestors, and lineal descendants.
3. If a person holds an option to buy stock, he or she is considered to be the owner of that stock.
4. When applying rule (1) or (2), stock considered owned by a person under rule (1) or (3) is treated as actually owned by that person. Stock considered owned by an individual under rule (2) is not treated as owned by the individual for again applying rule (2) to consider another the owner of that stock.

5. Stock that may be considered owned by an individual under either rule (2) or (3) is considered owned by the individual under rule (3).

PASSIVE ACTIVITY LIMITS

The passive activity rules generally limit your losses from passive activities to your passive activity income. Generally, you are in a passive activity if you have a trade or business activity in which you do not materially participate during the tax year, or you have a rental activity.

The passive activity rules apply to personal service corporations and closely held corporations (other than S corporations).

VII. Figuring Tax

After you figure a corporation's taxable income, you figure its tax. This section discusses the tax rate schedule, credits, recapture taxes, and the alternative minimum tax.

TAX RATE SCHEDULE

Most corporations figure their tax by using the following tax rate schedule. An exception to that rule applies to qualified personal service corporations. Other exceptions are discussed in the instructions for Schedule J (Form 1120).

Tax Rate Schedule

If taxable income (line 30, Form 1120) is:

Over -	But not over -	Tax is:	Of the amount over -
\$0	50,000	15%	-0-
50,000	75,000	\$7,500 + 25%	\$50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	-	35%	-0-

Qualified personal service corporation. A qualified personal service corporation is taxed at a flat rate of 35% on taxable income. A corporation is a qualified personal service corporation if it meets *both* of the following tests.

1. Substantially all the corporation's activities involve the performance of personal services.
2. At least 95% of the corporation's stock, by value, is owned, directly or indirectly, by any of the following.
 - a. Employees performing the personal services.
 - b. Retired employees who had performed the personal services.
 - c. An estate of the employee or retiree described above.
 - d. Any person who acquired the stock of the corporation as a result of the death of an employee or retiree (but only for the 2-year period beginning on the date of the employee's or retiree's death).

See section 1.448-1T(e) of the regulations for details.

ALTERNATIVE MINIMUM TAX (AMT)

The tax laws give special treatment to some types of income and allow special deductions and credits for some types of expenses. These laws enable some corporations with substantial economic income to significantly reduce their regular tax. The corporate alternative minimum tax (AMT) ensures that these corporations pay at least a minimum amount of tax on their economic income. A corporation (other than a small corporation exempt from the AMT) owes AMT if its tentative minimum tax is more than its regular tax.

Tip. *The tentative minimum tax of a small corporation is zero. This means that a small corporation will not owe AMT.*

Small corporation exemption. A corporation is treated as a small corporation exempt from the AMT for its current tax year if that year is the corporation's first tax year in existence (regardless of its gross receipts for the year) or:

1. It was treated as a small corporation exempt from the AMT for all prior tax years beginning after 1997, and
2. Its average annual gross receipts for the 3-tax-year period (or portion thereof during which the corporation was in existence) ending before its current tax year did not exceed \$7.5 million (\$5 million if the corporation had only 1 prior tax year).

Form 4626. Use Form 4626, Alternative Minimum Tax – Corporations, to figure the tentative minimum tax of a corporation that is not a small corporation for AMT purposes. For more information, see the Instructions for Form 4626.

CREDITS

A corporation's tax liability is reduced by allowable credits. The following list includes some credits available to corporations.

- Credit for federal tax on fuels used for certain nontaxable purposes.
- Credit for prior year minimum tax (see Form 8827).
- Foreign tax credit (see Form 1118).
- General business credit.
A corporation's general business credit consists of its carryforward of business credits from prior years plus the total current year business credits. For a list of allowable business credits, see Form 3800.
- Nonconventional source fuel credit (see section 29 of the Internal Revenue Code).
For tax years ending after December 31, 2005, the nonconventional source fuel credit is a general business credit included on Form 3800.
- Qualified plug-in electric and electric vehicle credit (see Form 8834).
- Clean renewable bond credit (see Form 8912).
- Gulf tax bond credit (see Form 8912).

RECAPTURE TAXES

A corporation's tax liability is increased if it recaptures credits it has taken in prior years. The following list includes credits a corporation may need to recapture.

- Employer-provided childcare facilities and services credit (see the instructions for Form 8882),
- Indian employment credit (see the instructions for Form 8845).
- Investment credit (see the instructions for Form 4255).
- Low-income housing credit (see the instructions for Form 8611).
- New markets credit (see the instructions for Form 8874).
- Qualified plug-in electric and electric vehicle credit (see the instructions for Form 8834).

VIII. Accumulated Earnings Tax

A corporation can accumulate its earnings for a possible expansion or other bona fide business reasons. However, if a corporation allows earnings to accumulate beyond the reasonable needs of the business, it may be subject to an accumulated earnings tax of 15%. If the accumulated earnings tax applies, interest applies to the tax from the date the corporate return was originally due, without extensions.

To determine if the corporation is subject to this tax, first treat an accumulation of \$250,000 or less generally as within the reasonable needs of most businesses. Treat an accumulation of \$150,000 or less as within the reasonable needs of a business whose principal function is performing services in the fields of accounting, actuarial science, architecture, consulting, engineering, health (including veterinary services), law, and the performing arts.

In determining if the corporation has accumulated earnings and profits beyond its reasonable needs, value the listed and readily marketable securities owned by the corporation and purchased with its earnings and profits at net liquidation value, not at cost.

Reasonable needs of the business include the following.

- Specific, definite, and feasible plans for use of the earnings accumulation in the business.
- The amount necessary to redeem the corporation's stock included in a deceased shareholder's gross estate, if the amount does not exceed the reasonably anticipated total estate and inheritance taxes and funeral and administration expenses incurred by the shareholder's estate.

The absence of a bona fide business reason for a corporation's accumulated earnings may be indicated by many different circumstances, such as a lack of regular distributions to its shareholders or withdrawals by the shareholders classified as personal loans. However, actual moves to expand the business generally qualify as a bona fide use of the accumulations.

The fact that a corporation has an unreasonable accumulation of earnings is sufficient to establish liability for the accumulated earnings tax unless the corporation can show the earnings were not accumulated to allow its individual shareholders to avoid income tax.

IX. Distributions to Shareholders

This section discusses corporate distributions of money, stock, or other property to a shareholder with respect to the shareholder's ownership of stock. However, this section does not discuss the special rules that apply to the following distributions.

- Distributions in redemption of stock – section 302.
- Distributions in complete liquidation of the corporation – sections 331 through 346.
- Distributions in corporate organizations – section 351. Also see *Property Exchanged for Stock*, earlier.
- Distributions in corporate reorganizations – sections 351 through 368.
- Certain distributions to 20% corporate shareholders – section 301(e).

MONEY OR PROPERTY DISTRIBUTIONS

Most distributions are in money, but they may also be in stock or other property. For this purpose, "property" generally does not include stock in the corporation or rights to acquire this stock. However, see *Distributions of Stock or Stock Rights*, later.

A corporation generally does not recognize a gain or loss on the distributions covered by the rules in this section. However, see *Gain from property distributions*, later.

Amount distributed. The amount of a distribution is generally the amount of any money paid to the shareholder plus the fair market value (FMV) of any property transferred to the shareholder. However, this amount is reduced (but not below zero) by the following liabilities.

- Any liability of the corporation the shareholder assumes in connection with the distribution.
- Any liability to which the property is subject immediately before, and immediately after, the distribution.

The FMV of any property distributed to a shareholder becomes the shareholder's basis in that property.

Gain from property distributions. A corporation will recognize a gain on the distribution of property to a shareholder if the FMV of the property is more than its adjusted basis. This is generally the same treatment the corporation would receive if the property were sold. However, for this purpose, the FMV of the property is the greater of the following amounts.

- The actual FMV.
- The amount of any liabilities the shareholder assumed in connection with the distribution of the property.

If the property was depreciable or amortizable, the corporation may have to treat all or part of the gain as ordinary income from depreciation recapture. For more information on depreciation recapture and the sale of business property, see Publication 544.

DISTRIBUTIONS OF STOCK OR STOCK RIGHTS

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights (also known as "stock options") are distributions by a corporation of rights to acquire its stock. Distributions of stock dividends and stock rights are generally tax-free to shareholders. However, stock and stock rights are treated as property under the rules discussed earlier under *Money or Property Distributions* if any of the following apply to their distribution.

1. Any shareholder has the choice to receive cash or other property instead of stock or stock rights.
2. The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders.
3. The distribution is in convertible preferred stock and has the same result as in (2).
4. The distribution gives preferred stock to some common stock shareholders and gives common stock to other common stock shareholders.
5. The distribution is on preferred stock. (An increase in the conversion ratio of convertible preferred stock made solely to take into account a stock dividend, stock split, or similar event that would otherwise result in reducing the conversion right is not a distribution on preferred stock.)

For this purpose, the term "stock" includes rights to acquire stock and the term "shareholder" includes a holder of rights or convertible securities.

Constructive stock distributions. You must treat certain transactions that increase a shareholder's proportionate interest in the earnings and profits or assets of a corporation as if they were distributions of stock or stock rights. These constructive distributions are treated as property if they have the same result as a distribution described in (2), (3), (4), or (5) of the above discussion. Constructive distributions are described later.

This treatment applies to a change in your stock's conversion ratio or redemption price, a difference between your stock's redemption price and issue price, a redemption that is not treated as a sale or exchange of your stock, and any other transaction having a similar effect on a shareholder's interest in the corporation.

Expenses of issuing a stock dividend. You cannot deduct the expenses of issuing a stock dividend. These expenses include printing, postage, cost of advice sheets, fees paid to transfer agents, and fees for listing on stock exchanges. The corporation must capitalize these costs.

CONSTRUCTIVE DISTRIBUTIONS

The following sections discuss transactions that may be treated as distributions.

Below-market loans. If a corporation gives a shareholder a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate, the

interest not charged may be treated as a distribution to the shareholder. For more information, see *Below-Market Loans* under *Income, Deductions, and Special Provisions*, earlier.

Corporation cancels shareholder's debt. If a corporation cancels a shareholder's debt without repayment by the shareholder, the amount canceled is treated as a distribution to the shareholder.

Transfers of property to shareholders for less than FMV. A sale or exchange of property by a corporation to a shareholder may be treated as a distribution to the shareholder. For a shareholder who is not a corporation, if the FMV of the property on the date of the sale or exchange exceeds the price paid by the shareholder, the excess may be treated as a distribution to the shareholder.

Unreasonable rents. If a corporation rents property from a shareholder and the rent is unreasonably more than the shareholder would charge to a stranger for use of the same property, the excessive part of the rent may be treated as a distribution to the shareholder.

Unreasonable salaries. If a corporation pays an employee who is also a shareholder a salary that is unreasonably high considering the services actually performed by the shareholder-employee, the excessive part of the salary may be treated as a distribution to the shareholder-employee.

REPORTING DIVIDENDS AND OTHER DISTRIBUTIONS

A corporate distribution to a shareholder is generally treated as a distribution of earnings and profits. Any part of a distribution from either current or accumulated earnings and profits is reported to the shareholder as a dividend. Any part of a distribution that is not from earnings and profits is applied against and reduces the adjusted basis of the stock in the hands of the shareholder. To the extent the balance is more than the adjusted basis of the stock, the shareholder has a gain (usually a capital gain) from the sale or exchange of property.

Form 1099-DIV. File Form 1099-DIV with the IRS for each shareholder to whom you have paid dividends and other distributions on stock of \$10 or more during a calendar year. You must generally send Forms 1099-DIV to the IRS with *Form 1096* by February 28 (March 31 if filing electronically) of the year following the year of the distribution. For more information, see the general instructions for Forms 1099, 1098, 5498, and W-2G.

Generally, you must furnish Forms 1099-DIV to shareholders by January 31 of the year following the close of the calendar year during which the corporation made the distributions. However, you may furnish the Form 1099-DIV to shareholders after November 30 of the year of the distributions if the corporation has made its final distributions for the year. You may furnish the Form 1099-DIV to shareholders anytime after April 30 of the year of the distributions if you give the Form 1099-DIV with the final distributions for the calendar year.

Backup withholding. Dividends may be subject to backup withholding. For more information on backup withholding, see the general instructions for Forms 1099, 1098, 5498, and W-2G.

Form 5452. File Form 5452 if nondividend distributions were made to shareholders.

A calendar tax year corporation must file Form 5452 with its income tax return for the tax year in which the nondividend distributions were made. A fiscal tax year corporation must file Form 5452 with its income tax return due for the first fiscal year ending after the calendar year in which the nondividend distributions were made.

Current year earnings and profits. If a corporation's earnings and profits for the year (figured as of the close of the year without reduction for any distributions made during the year) are more than the total amount of distributions made during the year, all distributions made during the year are treated as distributions of current year earnings and profits. If the total amount of distributions is more than the earnings and profits for the year, see *Accumulated earnings and profits*, later.

Example. You are the only shareholder of a corporation that uses the calendar year as its tax year. In January, you use the worksheet in the Form 5452 instructions to figure your corporation's current year earnings and profits for the previous year. During the year, the corporation made four \$1,000 distributions to you. At the end of the year (before subtracting distributions made during the year), the corporation had \$10,000 of current year earnings and profits.

Since the corporation's current year earnings and profits (\$10,000) were more than the amount of the distributions it made during the year (\$4,000), all of the distributions are treated as distributions of current year earnings and profits.

The corporation must issue a Form 1099-DIV to you by the end of January to report the \$4,000 distributed to you during the previous year as dividends. The corporation must use Form 1096 to report this information to the IRS by February 28 (March 31 if filing electronically). The corporation does not deduct these dividends on its income tax return.

Accumulated earnings and profits. If a corporation's current year earnings and profits (figured as of the close of the year without reduction for any distributions made during the year) are less than the total distributions made during the year, part or all of each distribution is treated as a distribution of accumulated earnings and profits. Accumulated earnings and profits are earnings and profits the corporation accumulated before the current year.

If the total amount of distributions is less than current year earnings and profits, see *Current year earnings and profits*, earlier.

Used with current year earnings and profits. If the corporation has current year earnings and profits, figure the use of accumulated and current earnings and profits as follows.

1. Divide the current year earnings and profits by the total distributions made during the year.
2. Multiply each distribution by the percentage figured in (1) to get the amount treated as a distribution of current year earnings and profits.
3. Start with the first distribution and treat the part of each distribution greater than the allocated current year earnings and profits figured in (2) as a distribution of accumulated earnings and profits.

4. If accumulated earnings and profits are reduced to zero, the remaining part of each distribution is applied against and reduces the adjusted basis of the stock in the hands of the shareholders. To the extent that the balance is more than the adjusted basis of the stock, it is treated as a gain from the sale or exchange of property.

Example. You are the only shareholder of a corporation that uses the calendar year as its tax year. In January, you use the worksheet in the Form 5452 instructions to figure your corporation's current year earnings and profits for the previous year. At the beginning of the year, the corporation's accumulated earnings and profits balance was \$20,000. During the year, the corporation made four \$4,000 distributions to you ($\$4,000 \times 4 = \$16,000$). At the end of the year (before subtracting distributions made during the year), the corporation had \$10,000 of current year earnings and profits.

Since the corporation's current year earnings and profits (\$10,000) were less than the distributions it made during the year (\$16,000), part of each distribution is treated as a distribution of accumulated earnings and profits. Treat the distributions as follows.

- Divide the current year earnings and profits (\$10,000) by the total amount of distributions made during the year (\$16,000). The result is .625.
- Multiply each \$4,000 distribution by the .625 figured in the point above to get the amount (\$2,500) of each distribution treated as a distribution of current year earnings and profits.
- The remaining \$1,500 of each distribution is treated as a distribution from accumulated earnings and profits. The corporation distributed \$6,000 ($\$1,500 \times 4$) of accumulated earnings and profits.

The remaining \$14,000 ($\$20,000 - \$6,000$) of accumulated earnings and profits is available for use in the following year.

The corporation must issue a Form 1099-DIV to you by the end of January to report the \$16,000 distributed to you during the previous year as dividends. The corporation must use Form 1096 to report this information to the IRS by February 28 (March 31 if filing electronically). The corporation does not deduct these dividends on its income tax return.

Used without current year earnings and profits. If the corporation has no current year earnings and profits, figure the use of accumulated earnings and profits as follows.

1. If the current year earnings and profits balance is negative, prorate the negative balance to the date of each distribution made during the year.
2. Figure the available accumulated earnings and profits balance on the date of each distribution by subtracting the prorated amount of current year earnings and profits from the accumulated balance.
3. Treat each distribution as a distribution of these adjusted accumulated earnings and profits.
4. If adjusted accumulated earnings and profits are reduced to zero, the remaining distributions are applied against and reduce the adjusted basis of the stock in the hands of the shareholders. To the extent that the balance is more than the adjusted basis of the stock, it is treated as a gain from the sale or exchange of property.

Example. You are the only shareholder of a corporation that uses the calendar year as its tax year. In January, you use the worksheet in the Form 5452 instructions to figure your corporation's current year earnings and profits for the previous year. At the beginning of the year, the corporation's accumulated earnings and profits balance was \$20,000. During the year, the corporation made four \$4,000 distributions to you on March 31, June 30, September 30, and December 31. At the end of the year (before subtracting distributions made during the year), the corporation had a negative \$10,000 current year earnings and profits balance.

Since the corporation had no current year earnings and profits, all of the distributions are treated as distributions of accumulated earnings and profits. Treat the distributions as follows.

- Prorate the negative current year earnings and profits balance to the date of each distribution made during the year. The negative \$10,000 can be spread evenly by prorating a negative \$2,500 to each distribution.
- The following table shows how to figure the available accumulated earnings and profits balance on the date of each distribution.

March 31 Distribution

Accumulated earnings and profits	\$20,000
Prorated current year earnings and profits	(\$2,500)
Accumulated earnings and profits available	\$17,500
Amount of distribution treated as a dividend	(\$4,000)

June 30 Distribution

Accumulated earnings and profits	\$13,500
Prorated current year earnings and profits	(\$2,500)
Accumulated earnings and profits available	\$11,000
Amount of distribution treated as a dividend	(\$4,000)

September 30 Distribution

Accumulated earnings and profits	\$7,000
Prorated current year earnings and profits	(\$2,500)
Accumulated earnings and profits available	\$4,500
Amount of distribution treated as a dividend	(\$4,000)

December 31 Distribution

Accumulated earnings and profits	\$500
Prorated current year earnings and profits	(\$2,500)
Accumulated earnings and profits available	(\$2,000)
Amount of distribution treated as a dividend	0
Nondividend amount (reduction of stock basis or gain from sale/exchange of property)	\$4,000
Year-end accumulated earnings and profits	(\$2,000)

The corporation must issue a Form 1099-DIV to you by the end of January to report \$12,000 of the \$16,000 distributed to you during the previous year as dividends. The corporation must use Form 1096 to report this information to the IRS by February 28 (March 31 if filing electronically). The corporation does not deduct these dividends on its income tax return. However, the corporation must attach Form 5452 to this return to report the nondividend distribution.

CHAPTER 1 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. If you transfer property to a corporation in exchange for stock in that corporation, and immediately afterward you are in control of the corporation, the exchange is usually not taxable.
 - a) true
 - b) false

2. You cannot deduct a loss from an exchange of property for stock if you own, directly or indirectly, more than:
 - a) 10% of the corporation's stock
 - b) 33% of the corporation's stock
 - c) 50% of the corporation's stock
 - d) 90% of the corporation's stock

3. Contributions to the capital of the corporation are taxable to the corporation.
 - a) true
 - b) false

4. If a corporation completes and files Form 7004 by the due date of its return, the corporation:
 - a) must also pay the tax due
 - b) can postpone paying the tax due for 6 months
 - c) can pay the tax due in installments over the next 6 months after the return due date
 - d) none of the above

5. If a corporation is required to make estimated payments, each required installment must be equal to 25% of the income tax the corporation will show on its return for the current year.
 - a) true
 - b) false

6. Which of the following forms should a corporation file for a quick refund of overpayments of estimated taxes:
- a) Form 1120
 - b) Form 2220
 - c) Form 4466
 - d) Form 7004
7. For purposes of deductible business expenses, a related person to a corporation is determined:
- a) at the time of the transaction
 - b) at the beginning of the corporation's tax year for which the expense would otherwise be deductible
 - c) at the beginning of the calendar year
 - d) at the end of the tax year for which the expense would otherwise be deductible
8. If a corporation owns 20% or more of the distributing corporation's stock, it can, subject to certain limits, deduct 80% of the dividends received.
- a) true
 - b) false
9. An extraordinary dividend is any dividend on stock that equals or exceeds a certain percentage of the corporation's adjusted basis in the stock.
- a) true
 - b) false
10. A cash method corporation can deduct contributions:
- a) in the tax year paid
 - b) in the year authorized by the board if paid by the 15th day of the 3rd month after the close of that tax year
 - c) either a or b above
 - d) none of the above; corporations cannot deduct charitable contributions
11. A corporation can deduct capital losses only up to the amount of its capital gains.
- a) true
 - b) false
12. The corporation who has taxable income of \$1,000,000 would pay income tax of:
- a) \$113,900
 - b) \$340,000
 - c) \$350,000
 - d) \$390,000

13. The tentative minimum tax for a small corporation is:
- a) zero
 - b) 10%
 - c) 15%
 - d) calculated the same for all other corporations
14. The accumulated earnings tax applies to corporations that allow earnings to accumulate beyond the reasonable needs of the business.
- a) true
 - b) false
15. If a corporation gives a shareholder a loan on which no interest is charged, the interest not charged may be treated as a distribution to the shareholder.
- a) true
 - b) false
16. A corporate distribution to a shareholder is generally treated as:
- a) salaries expense
 - b) a distribution of earnings and profits
 - c) an interest expense
 - d) a miscellaneous expense

CHAPTER 1 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** This rule applies to both individuals and to groups who transfer property to a corporation. It applies whether the corporation is being formed or is already operating.

B: False is incorrect. This rule does not apply if the corporation is an investment company, the property is transferred in a bankruptcy or similar proceeding in exchange for stock used to pay creditors, or the stock is received in exchange for the corporation's debt or for the interest on the corporation's debt that accrued while you held the debt.

(See page 1-1 of the course material.)

2. A: Incorrect. The percentage is greater than 10%.

B: Incorrect. The percentage of ownership is greater than 33%.

C: Correct. The basis of the stock received is generally the adjusted basis of the property transferred.

D: Incorrect. The limiting percentage of ownership is less than 90%.

(See page 1-3 of the course material.)

3. A: True is incorrect. Contributions to the capital of a corporation, whether or not by shareholders, are paid-in-capital. These contributions are not taxable to the corporation.

B: False is correct. The basis of property contributed to capital by a shareholder is the same as the basis the shareholder had in the property, increased by any gain the shareholder recognized on the exchange. The basis of property contributed to capital by a person other than a shareholder is zero.

(See page 1-4 of the course material.)

4. **A: Correct.** Form 7004 does not extend the time for paying the tax due on the return. It only grants a 6-month extension of time to file a corporation income tax return.

B: Incorrect. A corporation is not granted an extension for paying the income tax due. Interest and possible penalties will be charged on any part of the final tax due not shown as a balance due on Form 7004.

C: Incorrect. Filing Form 7004 does not grant payment by the installment method.

D: Incorrect. Since one of the responses was correct, none of the above cannot be a correct answer.

(See pages 1-5 to 1-6 of the course material.)

5. A: True is incorrect. Paying 25% at each installment is one of the methods that can be used, but it is not the only method. Large corporations must use this method after the first installment.

B: False is correct. Another allowable method for some corporations is to pay 25% of the income tax shown on the corporation's return for the previous year. To use this method, the corporation must have filed a return for the previous year, the return must have been for a full 12 months, and the return must have shown a positive tax liability (not zero). If a corporation's income is expected to vary during the year, it may be able to use the annualized income installment method or the adjusted seasonal installment method.

(See page 1-7 of the course material.)

6. A: Incorrect. Form 1120 is the income tax return for corporations.

B: Incorrect. Form 2220 is used by corporations to determine if a corporation is subject to the penalty for underpayment of estimated tax, and if so, the amount of the penalty.

C: Correct. Form 4466 should be filed before the 16th day of the 3rd month after the end of the tax year, but before the corporation files its income tax return.

D: Incorrect. Form 7004 is used to request a 6-month extension of time to file a corporation income tax return.

(See page 1-8 of the course material.)

7. A: Incorrect. The date for determining related person status is not as flexible as the date of the transaction.

B: Incorrect. The determination date is not as early as the beginning of the tax year.

C: Incorrect. The calendar year is not a defining period for related persons.

D: Correct. If a deduction is denied as of the end of the tax year, the rule will continue to apply even if the corporation's relationship with the person ends before the expense is includible in the gross income of that person.

(See page 1-9 of the course material.)

8. **A: True is correct.** Ownership is determined for these rules by the amount of voting power and value of the paying corporation's stock (other than certain preferred stock) the receiving corporation owns.

B: False is incorrect. If the corporation owns less than 20% of the corporation distributing the dividend, it can deduct, within certain limits, 70% of the dividends received. Small business investment companies can deduct 100% of the dividends received from taxable domestic corporations.

(See page 1-12 of the course material.)

9. **A: True is correct.** The percentages are 5% for stock preferred as to dividends or 10% for other stock.

B: False is incorrect. All dividends received that have ex-dividend dates within an 85 consecutive-day period should be treated as one dividend.

(See page 1-14 of the course material.)

10. **A: Correct.** A corporation using the cash method of accounting must deduct charitable contributions in the tax year paid. The amount of the deductible contributions is limited.

B: Incorrect. A corporation using the accrual method of accounting may deduct contributions that are authorized in the tax year, but not paid up to the 15th day of the third month after the close of that tax year. A cash method corporation does not have this option.

C: Incorrect. Only one of the responses is correct.

D: Incorrect. Corporations can deduct a limited amount of charitable contributions.

(See page 1-15 of the course material.)

11. **A: True is correct.** If a corporation has an excess capital loss, it cannot deduct the loss in the current tax year. Instead, it carries the loss to other tax years and deducts it from capital gains that occur in those years.

B: False is incorrect. An excess capital loss is first carried back three years, then two years, then one year, and then forward up to five years, for as long as there is still a capital loss to deduct. When you carry a net capital loss to another tax year, treat it as a short-term loss. It does not retain its original identity as long term or short term.

(See page 1-18 of the course material.)

12. A: Incorrect. This is the amount paid on taxable income of \$335,000.

B: Correct. This is calculated as $\$113,900 + (1,000,000 - 335,000) \times .34$, or $\$113,900 + 226,100 = \$340,000$.

C: Incorrect. This is an erroneous calculation of $\$1,000,000 \times 35\%$.

D: Incorrect. This is an erroneous calculation of $\$1,000,000 \times 39\%$.

(See page 1-23 of the course material.)

13. **A: Correct.** A small corporation will not owe alternative minimum tax (AMT).

B: Incorrect. There is not a set percentage for the AMT.

C: Incorrect. There is not a set percentage for the AMT.

D: Incorrect. Although the corporate alternative minimum tax (AMT) ensures that corporations pay at least a minimum amount of tax on their economic income, it does not apply to small corporations.

(See page 1-24 of the course material.)

14. **A: True is correct.** To determine if a corporation is subject to the accumulated earnings tax, earnings accumulation of \$250,000 or less is generally considered within the reasonable needs of most businesses. If the corporation's principal function is performing services in a variety of fields, the reasonable needs of a business are reduced to \$150,000 or less.

B: False is incorrect. The fact that a corporation has an unreasonable accumulation of earnings is sufficient to establish liability for the accumulated earnings tax unless the corporation can show the earnings were not accumulated to allow its individual shareholders to avoid income tax.

(See pages 1-25 to 1-26 of the course material.)

15. **A: True is correct.** Other transactions that may be treated as distributions include corporation cancellations of a shareholder's debt, transfers of property to shareholders for less than FMV, unreasonable rents, and unreasonable salaries.

B: False is incorrect. The treatment as a distribution of interest not charged also applies to loans where the interest rate charged is below the applicable federal rate.

(See pages 1-27 to 1-28 of the course material.)

16. A: Incorrect. A distribution to a shareholder is not generally for salaries.

B: Correct. Any part of the distribution from either current or accumulated earnings and profits is reported to the shareholder as a dividend.

C: Incorrect. Generally, these distributions are treated as a dividend, and not interest.

D: Incorrect. A distribution to a shareholder is not generally considered a miscellaneous expense.

(See page 1-28 of the course material.)

Chapter 2: Tax Filing Forms and Instructions for Corporate Returns

The following information and line item instructions are provided to assist in the completion of corporate tax returns.

Form 1120

I. What's New

New Schedule UTP (Form 1120), Uncertain Tax Position Statement.

Certain filers of Forms 1120, 1120-F, 1120-L, and 1120-PC with assets that equal or exceed \$100 million must file new Schedule UTP (Form 1120) to report uncertain tax positions.

Federal tax deposits must be made by electronic funds transfer.

Beginning January 1, 2011, corporations must use electronic funds transfers to make all federal tax deposits (such as deposits of employment tax, excise tax, and corporate income tax). Forms 8109 and 8109-B, Federal Tax Coupon, cannot be used after December 31, 2010.

Special rules for eligible small business credits.

For tax years beginning in 2010, if the corporation is an eligible small business, eligible small business credits are not subject to the alternative minimum tax (AMT). In addition, eligible small business credits can be carried back five years and will not be subject to AMT in the carryback years. For more information, see the instructions for Form 3800.

Special rule for 2010 start-up costs.

For tax years beginning in 2010, a corporation can elect to deduct up to \$10,000 of start-up costs. See section 195(b)(3).

Extension of election to accelerate the AMT credit in lieu of bonus depreciation.

A corporation can elect to increase the minimum tax credit limitation in lieu of bonus depreciation on certain "round two" extension property placed in service after December 31, 2010, in tax years ending after such date. See section 168(k)(4)(D)(iii).

II. General Instructions

Special Returns for Certain Organizations

Instead of filing Form 1120, certain organizations, as shown below, have to file special returns.

If the organization is a:	File Form:
Exempt organization with unrelated trade or business income	990-T
Religious or apostolic organization exempt under section 501(d)	1065
Entity formed as a limited liability company under state law and treated as a partnership for federal income tax purposes	1065
Subchapter T cooperative association (including a farmers' cooperative)	1120-C
Entity that elects to be treated as a real estate mortgage investment conduit (REMIC) under section 860D	1066
Interest charge domestic international sales corporation (section 992)	1120-IC-DISC
Foreign corporation (other than life and property and casualty insurance company filing Form 1120-L or Form 1120-PC)	1120-F
Foreign sales corporation (section 922)	1120-FSC
Condominium management, residential real estate management, or timeshare association that elects to be treated as a homeowners association under section 528	1120-H
Life insurance company (section 801)	1120-L
Fund set up to pay for nuclear decommissioning costs (section 468A)	1120-ND
Property and casualty insurance company (section 831)	1120-PC
Political organization (section 527)	1120-POL
Real estate investment trust (section 856)	1120-REIT
Regulated investment company (section 851)	1120-RIC
S corporation (section 1361)	1120S
Settlement fund (section 468B)	1120-SF

WHEN TO FILE

Generally, a corporation must file its income tax return by the 15th day of the 3rd month after the end of its tax year. A new corporation filing a short-period return must generally file by the 15th day of the 3rd month after the short period ends. A corporation that has dissolved must generally file by the 15th day of the 3rd month after the date it dissolved.

If the due date falls on a Saturday, Sunday, or legal holiday, the corporation can file on the next business day.

WHO MUST SIGN

The return must be signed and dated by:

- The president, vice president, treasurer, assistant treasurer, chief accounting officer or
- Any other corporate officer (such as tax officer) authorized to sign.

If a return is filed on behalf of a corporation by a receiver, trustee or assignee, the fiduciary must sign the return, instead of the corporate officer. Returns and forms signed by a receiver or trustee in bankruptcy on behalf of a corporation must be accompanied by a copy of the order or instructions of the court authorizing signing of the return or form.

If an employee of the corporation completes Form 1120, the paid preparer's space should remain blank. Anyone who prepares Form 1120 but does not charge the corporation should not complete that section. Generally, anyone who is paid to prepare the return must sign it and fill in the "Paid Preparer's Use Only" area.

The **paid preparer** must complete the required preparer information and –

- Sign the return in the space provided for the preparer's signature.
- Give a copy of the return to the taxpayer.

Note. A paid preparer may sign original returns, amended returns, or requests for filing extensions by rubber stamp, mechanical device, or computer software program.

Interest and Penalties

Interest. Interest is charged on taxes paid late even if an extension of time to file is granted. Interest is also charged on penalties imposed for failure to file, negligence, fraud, substantial valuation misstatements, and substantial understatements of tax from the due date (including extensions) to the date of payment. The interest charge is figured at a rate determined under section 6621.

Late filing of return. A corporation that does not file its tax return by the due date, including extensions, may be penalized 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax. The minimum penalty for a return that is over 60 days late is the smaller of the tax due or \$135. The penalty will not be imposed if the corporation can show that the failure to file on time was due to reasonable cause. Corporations that file late should attach a statement explaining the reasonable cause.

Late payment of tax. A corporation that does not pay the tax when due generally may be penalized ½ of 1% of the unpaid tax for each month or part of a month the tax is not paid, up to a maximum of 25% of the unpaid tax. The penalty will not be imposed if the corporation can show that the failure to pay on time was due to reasonable cause.

ACCOUNTING METHODS

Figure taxable income using the method of accounting regularly used in keeping the corporation's books and records. In all cases, the method used must clearly show taxable income. Permissible methods include cash, accrual, or any other method authorized by the Internal Revenue Code.

Generally, the following rules apply.

- A corporation (other than a qualified personal service corporation) must use the accrual method of accounting if its average annual gross receipts exceed \$5 million.
- Unless it is a qualifying taxpayer or a qualifying small business taxpayer, a corporation must use the accrual method for sales and purchases of inventory items.
- A corporation engaged in farming must use the accrual method. For exceptions, see section 447.
- Special rules apply to long-term contracts. See section 460.
- Dealers in securities must use the mark-to-market accounting method. Dealers in commodities and traders in securities and commodities can elect to use the mark-to-market accounting method. See section 475.

Change in accounting method. Generally, the corporation must get IRS consent to change the method of accounting used to report taxable income (for income as a whole or for the treatment of any material item). To do so, the corporation generally must file Form 3115, Application for Change in Accounting Method.

ACCOUNTING PERIOD

A corporation must figure its taxable income on the basis of a tax year. A tax year is the annual accounting period a corporation uses to keep its records and report its income and expenses. Generally, corporations can use a calendar year or a fiscal year. Personal service corporations, however, must use a calendar year unless they meet one of the exceptions.

Change of tax year. Generally, a corporation, including a personal service corporation, must get the consent of the IRS before changing its tax year by filing Form 1128, Application To Adopt, Change, or Retain a Tax Year. However, under certain conditions, a corporation can change its tax year without getting the consent.

III. Specific Instructions

INCOME

Except as otherwise provided in the Internal Revenue Code, gross income includes all income from whatever source derived.

Line 1. Gross Receipts or Sales

Enter gross receipts or sales from all business operations except those that must be reported on lines 4 through 10. In general, advance payments are reported in the year of receipt.

Installment sales. Generally, the installment method cannot be used for dealer dispositions of property. A “dealer disposition” is any disposition of: (a) personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan or (b) real property held for sale to customers in the ordinary course of the taxpayer’s trade or business.

These restrictions on using the installment method do not apply to dispositions of property used or produced in a farming business or sales of timeshares and residential lots for which the corporation elects to pay interest under section 453(l)(3).

For sales of timeshares and residential lots reported under the installment method, the corporation’s income tax is increased by the interest payable under section 453(l)(3). To report this addition to the tax, see the instructions for line 9, Schedule J.

Enter on line 1 (and carry to line 3), the gross profit on collections from installment sales for any of the following.

- Dealer dispositions of property before March 1, 1986.
- Dispositions of property used or produced in the trade or business of farming.
- Certain dispositions of timeshares and residential lots reported under the installment method.

Attach a schedule showing the following information for the current and the 3 preceding years: (a) gross sales, (b) cost of goods sold, (c) gross profits, (d) percentage of gross profits to gross sales, (e) amount collected, and (f) gross profit on the amount collected.

Nonaccrual experience method. Accrual method corporations are not required to accrue certain amounts to be received from the performance of services that, on the basis of their experience, will not be collected, if:

- The services are in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting or
- The corporation’s average annual gross receipts for the 3 prior tax years does not exceed \$5 million.

This provision does not apply to any amount if interest is required to be paid on the amount or if there is any penalty for failure to timely pay the amount. For more information, see section 448(d)(5) and Temporary Regulations section 1.448-2.

Corporations that qualify to use the nonaccrual experience method should attach a schedule showing total gross receipts, the amount not accrued as a result of the application of section 448(d)(5), and the net amount accrued. Enter the net amount on line 1a.

Line 2. Cost of Goods Sold

Enter the cost of goods sold on line 2, page 1. Before making this entry, a Form 1120 filer must complete Schedule A on page 2 of Form 1120. See the Schedule A instructions.

Line 4. Dividends

Form 1120 filers. See the instructions for Schedule C. Then, complete Schedule C and enter on line 4 the amount from Schedule C, line 19.

Line 5. Interest

Enter taxable interest on U.S. obligations and on loans, notes, mortgages, bonds, bank deposits, corporate bonds, tax refunds, etc. Do not offset interest expense against interest income. Special rules apply to interest income from certain below-market-rate loans. See section 7872 for details.

Note. Report tax-exempt interest income on Schedule K, item 9. Also, if required, include the same amount on Schedule M-1, line 7 or Schedule M-3, Part II, line 13, if applicable.

Line 6. Gross Rents

Enter the gross amount received for the rental of property. Deduct expenses such as repairs, interest, taxes, and depreciation on the proper lines for deductions. A rental activity held by a closely held corporation or a personal service corporation may be subject to the passive activity loss rules.

Line 10. Other Income

Enter any other taxable income not reported on lines 1 through 9. List the type and amount of income on an attached schedule. If the corporation has only one item of other income, describe it in parentheses on line 10. Examples of other income to report on line 10 include the following:

- Recoveries of bad debts deducted in prior years under the specific charge-off method.
- The amount included in income from Form 6478, Alcohol and Cellulosic Biofuel Fuels Credit.
- The amount included in income from Form 8864, Biodiesel and Renewable Diesel Fuels Credit.
- Refunds of taxes deducted in prior years to the extent they reduced income subject to tax in the year deducted (see section 111). Do not offset current year taxes against tax refunds.

- Any recapture amount under section 179A for certain clean-fuel vehicle property (or clean-fuel vehicle refueling property) that ceases to qualify.
- Ordinary income from trade or business activities of a partnership (from Schedule K-1 (Form 1065 or 1065-B)). Do not offset ordinary losses against ordinary income. Instead, include the losses on line 26, Form 1120. Show the partnership's name, address, and EIN on a separate statement attached to this return. If the amount entered is from more than one partnership, identify the amount from each partnership.
- Any **LIFO recapture** amount under section 1363(d). The corporation may have to include a LIFO recapture amount in income if it:
 1. Used the LIFO inventory method for its last tax year before the first tax year for which it elected to become an S corporation or
 2. Transferred LIFO inventory assets to an S corporation in a nonrecognition transaction in which those assets were transferred basis property.

The LIFO recapture amount is the amount by which the C corporation's inventory under the FIFO method exceeds the inventory amount under the LIFO method at the close of the corporation's last tax year as a C corporation (or for the year of the transfer, if (b) above applies). See the instructions for Schedule J, line 10.

- Any net positive section 481(a) adjustment. The corporation may have to make an adjustment under section 481(a) to prevent amounts of income or expense from being duplicated or omitted. The section 481(a) adjustment period is generally 1 year for a net negative adjustment and 4 years for a net positive adjustment. However, a corporation can elect to use a 1-year adjustment period if the net section 481(a) adjustment for the change is less than \$25,000. The corporation must complete the appropriate lines of Form 3115 to make the election. If the net section 481(a) adjustment is negative, report it on line 26.
- Part or all of the proceeds received from certain corporate-owned life insurance contracts issued after August 17, 2006. Corporations that own one or more employer-owned life insurance contracts issued after this date must file Form 8925, Report of Employer-Owned Life Insurance Contracts. See section 101(j) for details.
- Income from cancellation of debt for the repurchase of a debt instrument for less than its adjusted issue price. However, for a reacquisition of an applicable debt instrument after December 31, 2008, and before January 1, 2011, a corporation can elect, under section 108(i), to defer the income from cancellation of debt in connection with the election. If the corporation makes the election, the income is deferred and ratably included in income over the 5-year period beginning with:

1. For a reacquisition occurring in 2009, the fifth tax year following the tax year in which the reacquisition occurs, and
2. For a reacquisition occurring in 2010, the fourth tax year following the tax year in which the reacquisition occurs.

To make the election for a 2010 reacquisition, attach a statement to the corporation's 2010 tax return. The statement must clearly identify the applicable instrument and include the amount of income to which the election applies. Once made, the election is irrevocable. See section 108(i).

DEDUCTIONS

Limitations on Deductions

Section 263A uniform capitalization rules. The uniform capitalization rules of section 263A generally require corporations to capitalize, or include in inventory, certain costs incurred in connection with:

- The production of real property and tangible personal property held in inventory or held for sale in the ordinary course of business.
- Real property or personal property (tangible and intangible) acquired for resale.
- The production of real property and tangible personal property by a corporation for use in its trade or business or in an activity engaged in for profit.

Tangible personal property produced by a corporation includes a film, sound recording, videotape, book, or similar property.

Corporations subject to the section 263A uniform capitalization rules are required to capitalize:

1. Direct costs, and
2. An allocable part of most indirect costs (including taxes) that (a) benefit the assets produced or acquired for resale or (b) are incurred because of the performance of production or resale activities.

For inventory, some of the indirect expenses that must be capitalized are:

- Administration expenses;
- Taxes;
- Depreciation;
- Insurance;
- Compensation paid to officers attributable to services;
- Rework labor; and
- Contributions to pension, stock bonus, and certain profit-sharing, annuity, or deferred compensation plans.

Regulations section 1.263A-1(e)(3) specifies other indirect costs that relate to production or resale activities that must be capitalized and those that may be currently deductible.

Interest expense paid or incurred during the production period of designated property must be capitalized and is governed by special rules.

The costs required to be capitalized under section 263A are not deductible until the property (to which the costs relate) is sold, used, or otherwise disposed of by the corporation.

Exceptions. Section 263A does not apply to:

- Personal property acquired for resale if the corporation's (or any predecessor's) average annual gross receipts for the 3 prior tax years were \$10 million or less.
- Timber.
- Most property produced under a long-term contract.
- Certain property produced in a farming business.
- Research and experimental costs under section 174.
- Geological and geophysical costs amortized under section 167(h).
- Capital costs incurred to comply with EPA sulfur regulations,
- Intangible drilling costs for oil, gas, and geothermal property.
- Mining exploration and development costs.
- Inventoriable items accounted for in the same manner as materials and supplies that are not incidental.

Transactions between related taxpayers. Generally, an accrual basis taxpayer can only deduct business expenses and interest owed to a related party in the year the payment is included in the income of the related party. See sections 163(e)(3), 163(j), and 267 for limitations on deductions for unpaid interest and expenses.

Section 291 limitations. Corporations may be required to adjust deductions for depletion of iron ore and coal, intangible drilling and exploration and development costs, certain deductions for financial institutions, and the amortizable basis of pollution control facilities. See section 291 to determine the amount of the adjustment. Also see section 43.

Golden parachute payments. A portion of the payments made by a corporation to key personnel that exceeds their usual compensation may not be deductible. This occurs when the corporation has an agreement (golden parachute) with these key employees to pay them these excess amounts if control of the corporation changes. See section 280G and Regulations section 1.280G-1.

Business start-up and organizational costs. A corporation can elect to deduct up to \$5,000 of business start-up and up to \$5,000 of organizational costs paid or incurred after October 22, 2004. Any remaining costs must be amortized. The \$5,000 deduction is reduced (but not below zero) by the amount the total costs exceed \$50,000. If the total costs are \$55,000 or more, the deduction is reduced to zero.

Special rule for 2010 start-up costs. For a tax year beginning in 2010, a corporation can elect to deduct up to \$10,000 of business start-up costs paid or incurred after December 31, 2009. The \$10,000 deduction is reduced (but not below zero) by the amount such start-up costs exceed \$60,000. Any remaining costs must be amortized.

Time for making an election. The corporation generally elects to deduct start-up or organizational costs by claiming the deduction on its income tax return filed by the due date (including extensions) for the tax year in which the active trade or business begins. However, for start-up or organizational costs paid or incurred before September 9, 2008, the corporation may be required to attach a statement to its return to elect to deduct such costs. See Temporary Regulations sections 1.195-1T and 1.248-1T.

If the corporation timely filed its return for the year without making an election, it can still make an election by filing an amended return within 6 months of the due date of the return (excluding extensions). Clearly indicate the election on the amended return and write "Filed pursuant to section 301.9100-2" at the top of the amended return. File the amended return at the same address the corporation filed its original return. The election applies when figuring taxable income for the current tax year and all subsequent years.

Note. The corporation can choose to forgo the elections above by clearly electing to capitalize its start-up or organizational costs on an income tax return filed by the due date (including extensions) for the tax year in which the active trade or business begins.

Report the deductible amount of start-up and organizational costs and any amortization on line 26. For amortization that begins during the 2010 tax year, complete and attach Form 4562.

Passive activity limitations. Limitations on passive activity losses and credits under section 469 apply to personal service corporations, and closely held corporations.

Generally, the two kinds of passive activities are:

- Trade or business activities in which the corporation did not materially participate for the tax year; and
- Rental activities, regardless of its participation.

For exceptions, see Form 8810, Corporate Passive Activity Loss and Credit Limitations.

Corporations subject to the passive activity limitations must complete Form 8810 to compute their allowable passive activity loss and credit.

Reducing certain expenses for which credits are allowable. If the corporation claims certain credits, it may need to reduce the otherwise allowable deductions for expenses used to figure the credit. The following are examples of such credits.

- Work opportunity credit.
- Credit for increasing research activities.
- Empowerment zone and renewal community credit.
- Indian employment credit.
- Research credit.
- Orphan drug credit.
- Disabled access credit.
- Employer credit for social security and Medicare taxes paid on certain employee tips.

- Credit for small employer pension plan startup costs.
- Credit for employer-provided childcare facilities and services.
- Low sulfur diesel fuel production credit.
- Mine rescue team training credit.
- Agricultural chemicals security credit.
- Credit for employer differential wage payments.
- Credit for small employer health insurance premiums.

If the corporation has any of these credits, figure each current year credit before figuring the deduction for expenses on which the credit is based. If the corporation capitalized any costs on which it figures the credit, reduce the amount capitalized by the credit attributable to these costs.

Line 12. Compensation of Officers

Enter deductible officers' compensation on line 12. Do not include compensation deductible elsewhere on the return, such as amounts included in cost of goods sold, elective contributions to a section 401(k) cash or deferred arrangement, or amounts contributed under a salary reduction SEP agreement or a SIMPLE IRA plan.

Complete Schedule E if the total receipts (line 1a, plus lines 4 through 10) are \$500,000 or more. Include only the deductible part of each officer's compensation on Schedule E. See *Disallowance of deduction for employee compensation in excess of \$1 million* below. Complete Schedule E, line 1, columns (a) through (f), for all officers. The corporation determines who is an officer under the laws of the state where it is incorporated.

If a consolidated return is filed, each member of an affiliated group must furnish this information.

Disallowance of deduction for employee compensation in excess of \$1 million. Publicly held corporations cannot deduct compensation to a "covered employee" to the extent that the compensation exceeds \$1 million. Generally, a covered employee is:

- The principal executive officer of the corporation (or an individual acting in that capacity) as of the end of the tax year or
- An employee whose total compensation must be reported to shareholders under the Securities Exchange Act of 1934 because the employee is among the three highest compensated officers for that tax year (other than the principal executive officer).

For this purpose, compensation does not include the following.

- Income from certain employee trusts, annuity plans, or pensions.
- Any benefit paid to an employee that is excluded from the employee's income.

The deduction limit does not apply to:

- Commissions based on individual performance,
- Qualified performance-based compensation, and
- Income payable under a written, binding contract in effect on February 17, 1993.

The \$1 million limit is reduced by amounts disallowed as excess parachute payments under section 280G.

Limitations on tax benefits for executive compensation under the Treasury Troubled Asset Relief Program (TARP). The \$1 million compensation limit is reduced to \$500,000 for executive remuneration and deferred deduction executive remuneration paid to covered executives by any entity that receives or has received financial assistance under TARP. The limit applies for each period in which obligations arising from financial assistance under TARP remain outstanding. The \$500,000 is reduced by any amounts disallowed as excess parachute payments. See section 162(m)(5) for definitions and other special rules.

In addition, a portion of any parachute payments made to a covered executive by an applicable employer participating in a Treasury troubled asset relief program is not deductible as compensation if the payments are made because of a severance from employment during an applicable tax year. For this purpose, a parachute payment is any payment to a senior executive officer for departure from a company for any reason, except for payments for services performed or benefits accrued. These limits do not apply to a payment already treated as a parachute payment. See section 280G(e) and Notice 2008-94.

Line 13. Salaries and Wages

Enter the total salaries and wages paid for the tax year. Do not include salaries and wages deductible elsewhere on the return, such as amounts included in officers' compensation, cost of goods sold, elective contributions to a section 401(k) cash or deferred arrangement, or amounts contributed under a salary reduction SEP agreement or a SIMPLE IRA plan.

If the corporation claims a credit for any wages paid or incurred, it may need to reduce its deduction for officer's compensation and salaries and wages. See *Reducing certain expenses for which credits are allowable*, earlier.

If the corporation provided taxable fringe benefits to its employees, such as personal use of a car, do not deduct as wages the amount allocated for depreciation and other expenses claimed on lines 20 and 26.

Line 14. Repairs and Maintenance

Enter the cost of incidental repairs and maintenance not claimed elsewhere on the return, such as labor and supplies, that do not add to the value of the property or appreciably prolong its life. New buildings, machinery, or permanent improvements that increase the value of the property are not deductible. They must be depreciated or amortized.

Line 15. Bad Debts

Enter the total debts that became worthless in whole or in part during the tax year. A small bank or thrift institution using the reserve method of section 585 should attach a schedule showing how it figured the current year's provision. A cash basis taxpayer cannot claim a bad debt deduction unless the amount was previously included in income.

Line 16. Rents

If the corporation rented or leased a vehicle, enter the total annual rent or lease expense paid or incurred during the year. Also complete Part V of Form 4562, Depreciation and Amortization. If the corporation leased a vehicle for a term of 30 days or more, the deduction for vehicle lease expense may have to be reduced by an amount called the inclusion amount. The corporation may have an inclusion amount if:

The lease term began:	And the vehicle's FMV on the first day of the lease exceeded:
After 12/31/07 but before 1/1/11	\$18,500
After 12/31/06 but before 1/1/08	\$15,500
After 12/31/04 but before 1/1/07	\$15,200
After 12/31/03 but before 1/1/05	\$17,500

If the lease term began before January 1, 2004, see Pub. 463, Travel, Entertainment, Gift, and Car Expenses, to find out if the corporation has an inclusion amount. The inclusion amount for lease terms beginning in 2011 will be published in the Internal Revenue Bulletin in early 2011.

Line 17. Taxes and Licenses

Enter taxes paid or accrued during the tax year, but do not include the following.

- Federal income taxes.
- Foreign or U.S. possession income taxes if a tax credit is claimed.
- Taxes not imposed on the corporation.
- Taxes, including state or local sales taxes, that are paid or incurred in connection with an acquisition or disposition of property (these taxes must be treated as a part of the cost of the acquired property or, in the case of a disposition, as a reduction in the amount realized on the disposition).
- Taxes assessed against local benefits that increase the value of the property assessed (such as for paving, etc.).
- Taxes deducted elsewhere on the return, such as those reflected in cost of goods sold.

Line 18. Interest

Note. Do not offset interest income against interest expense.

The corporation must make an interest allocation if the proceeds of a loan were used for more than one purpose (for example, to purchase a portfolio investment and to acquire an interest in a passive activity).

Mutual savings banks, building and loan associations, and cooperative banks can deduct the amounts paid or credited to the accounts of depositors as dividends, interest, or earnings.

Do not deduct the following interest.

- Interest on indebtedness incurred or continued to purchase or carry obligations if the interest is wholly exempt from income tax. For exceptions, see section 265(b). Also see section 265(b)(7) for a temporary de minimis exception for financial institutions for certain tax-exempt bonds issued in 2009 and 2010.
- For cash basis taxpayers, prepaid interest allocable to years following the current tax year. For example, a cash basis calendar year taxpayer who in 2010 prepaid interest allocable to any period after 2010 can deduct only the amount allocable to 2010.
- Interest and carrying charges on straddles. Generally, these amounts must be capitalized.
- Interest on debt allocable to the production of designated property by a corporation for its own use or for sale. The corporation must capitalize this interest. Also capitalize any interest on debt allocable to an asset used to produce the property.
- Interest paid or incurred on any portion of an underpayment of tax that is attributable to an understatement arising from an undisclosed listed transaction or an undisclosed reportable avoidance transaction (other than a listed transaction) entered into in tax years beginning after October 22, 2004.

Special rules apply to:

- Disqualified interest on certain indebtedness under section 163(j).
- Interest on which no tax is imposed (see section 163(j)). A corporation that owns an interest in a partnership, directly or indirectly, must treat its distributive share of the partnership liabilities, interest income, and interest expense as liabilities, income, and expenses of the corporation for purposes of applying the earnings stripping rules. For more details, see section 163(j)(8).
- Foregone interest on certain below-market-rate loans, see section 7872.
- Original issue discount on certain high-yield discount obligations. See section 163(e)(5) to determine the amount of the deduction for original issue discount that is deferred and the amount that is disallowed on a high-yield discount obligation. The rules under section 163(e)(5) do not apply to certain high-yield discount obligations issued after August 31, 2008 and before January 1, 2011. See section 163(e)(5)(F).
- Interest which is allocable to unborrowed policy cash values of life insurance, endowment, or annuity contracts issued after June 8, 1997. See section 264(f). Attach a statement showing the computation of the deduction.
- Section 108(i) OID deduction. If the corporation made an election under section 108(i) to defer the applicable income from cancellation of debt, and reacquires (or is treated as reacquiring) an applicable debt instrument, and, as part of the reacquisition, issues a debt instrument with OID that is subject to section 108(i)(2), the interest deduction for this OID is deferred. The accrued OID is allowed as a deduction ratably over the 5-year period that the income from cancellation of debt is includible in income. The deduction is limited to the income from the canceled debt with respect to the debt instrument reacquired. See section 108(i) for more details.

Line 19. Charitable Contributions

Enter contributions or gifts actually paid within the tax year to or for the use of charitable and governmental organizations described in section 170(c) and any unused contributions carried over from prior years. Special rules and limits apply to contributions to organizations conducting lobbying activities.

Corporations reporting taxable income on the accrual method can elect to treat as paid during the tax year any contributions paid by the 15th day of the 3rd month after the end of the tax year if the contributions were authorized by the board of directors during the tax year. Attach a declaration to the return stating that the resolution authorizing the contributions was adopted by the board of directors during the tax year. The declaration must include the date the resolution was adopted.

Caution. *If the corporation contributed money for the relief of victims in areas affected by the January 12, 2010 earthquake in Haiti and chose to deduct those amounts on its 2009 return instead of its 2010 return, **do not** include those amounts again on line 19.*

Limitation on deduction. The total amount claimed cannot be more than 10% of taxable income (line 30) computed without regard to the following.

- Any deduction for contributions.
- The special deductions on line 29b.
- The limitation under section 249 on the deduction for bond premium.
- The domestic production activities deduction under section 199.
- Any net operating loss (NOL) carryback to the tax year under section 172.
- Any capital loss carryback to the tax year under section 1212(a)(1).

Suspension of 10% limitation for farmers and ranchers. A corporation that is a qualified farmer or rancher (as defined in section 170(b)(1)(E)) that does not have publicly traded stock, can deduct contributions of qualified conservation property without regard to the general 10% limit. The total amount of the contribution claimed for the qualified conservation property cannot exceed 100% of the excess of the corporation's taxable income (as computed above substituting "100%" for "10%") over all other allowable charitable contributions. Any excess qualified conservation contributions can be carried over to the next 15 years subject to the 100% limitation. See section 170(b)(2)(B).

Carryover. Charitable contributions over the 10% limitation cannot be deducted for the tax year but can be carried over to the next 5 tax years.

Special rules apply if the corporation has an NOL carryover to the tax year. In figuring the charitable contributions deduction for the tax year, the 10% limit is applied using the taxable income after taking into account any deduction for the NOL.

To figure the amount of any remaining NOL carryover to later years, taxable income must be modified (see section 172(b)). To the extent that contributions are used to reduce taxable income for this purpose and increase an NOL carryover, a contributions carryover is not allowed. See section 170(d)(2)(B).

Cash contributions. For contributions of cash, check, or other monetary gifts (regardless of the amount), the corporation must maintain a bank record, or a receipt, letter, or other written communication from the donee organization indicating the name of the organization, the date of the contribution, and the amount of the contribution.

Contributions of \$250 or more. Generally, no deduction is allowed for any contribution of \$250 or more unless the corporation gets a written acknowledgment from the donee organization that shows the amount of cash contributed, describes any property contributed, and, either gives a description and a good faith estimate of the value of any goods or services provided in return for the contribution or states that no goods or services were provided in return for the contribution. The acknowledgment must be obtained by the due date (including extensions) of the corporation's return, or, if earlier, the date the return is filed. Do not attach the acknowledgment to the tax return, but keep it with the corporation's records.

Contributions of property other than cash. If a corporation (other than a closely held or personal service corporation) contributes property other than cash and claims over a \$500 deduction for the property, it must attach a schedule to the return describing the kind of property contributed and the method used to determine its fair market value (FMV). Closely held corporations and personal service corporations must complete Form 8283 and attach it to their returns. All other corporations generally must complete and attach Form 8283 to their returns for contributions of property (other than money) if the total claimed deduction for all property contributed was more than \$5,000. Special rules apply to the contribution of certain property. See the Instructions for Form 8283.

Other special rules. The corporation must reduce its deduction for contributions of certain capital gain property. See sections 170(e)(1) and 170(e)(5).

A larger deduction is allowed for certain contributions of:

- Inventory and other property to certain organizations for use in the care of the ill, needy, or infants (section 170(e)(3)), including contributions of "apparently wholesome food" (section 170(e)(3)(C)) and qualified book contributions (section 170(e)(3)(D));
- Scientific equipment used for research to institutions of higher learning or to certain scientific research organizations (other than by personal holding companies and service organizations (section 170(e)(4)); and
- Computer technology and equipment for educational purposes (section 170(e)(6)).

Line 20. Depreciation

Include on line 20 depreciation and the part of the cost of certain property that the corporation elected to expense under section 179. See Form 4562 and its instructions.

Line 21. Depletion

See sections 613 and 613A for percentage depletion rates applicable to natural deposits. Also see section 291 for the limitation on the depletion deduction for iron ore and coal (including lignite).

Attach Form T (Timber), Forest Activities Schedule, if a deduction for depletion of timber is taken.

Foreign intangible drilling costs and foreign exploration and development costs must either be added to the corporation's basis for cost depletion purposes or be deducted ratably over a 10-year period. See sections 263(i), 616, and 617 for details.

Line 23. Pension, Profit-Sharing, etc., Plans

Enter the deduction for contributions to qualified pension, profit-sharing, or other funded deferred compensation plans. Employers who maintain such a plan generally must file one of the forms listed below, even if the plan is not a qualified plan under the Internal Revenue Code. The filing requirement applies even if the corporation does not claim a deduction for the current tax year. There are penalties for failure to file these forms on time and for overstating the pension plan deduction. See sections 6652(e) and 6662(f).

Form 5500, Annual Return/Report of Employee Benefit Plan.

Form 5500-SF. Short Form Annual Return/Report of Small Employee Benefit Plan, instead of Form 5500, generally if under 100 participants at the beginning of the plan year.

Note: Form 5500 and 5500-SF must be filed electronically under the computerized ERISA Filing Acceptance System (EFAST2).

Form 5500-EZ, Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan. File this form for a plan that only covers the owner (or the owner and his or her spouse) but only if the owner (or the owner and his or her spouse) owns the entire business.

Line 24. Employee Benefit Programs

Enter contributions to employee benefit programs not claimed elsewhere on the return (for example, insurance, health and welfare programs, etc.) that are not an incidental part of a pension, profit-sharing, etc., plan included on line 23.

Line 26. Other Deductions

Attach a schedule, listing by type and amount, all allowable deductions that are not deductible elsewhere on Form 1120. Enter the total of other deductions on line 26.

Examples of other deductions include the following.

- Amortization. See Part VI of Form 4562.
- Certain costs of qualified film or television productions. See section 181.
- Certain business start-up and organizational costs.
- Certain environmental remediation costs. See section 1400N(g) and Pub. 4492-B.
- Certain qualified disaster expenses that the corporation elects to deduct. See section 198A.
- Reforestation costs. The corporation can elect to deduct up to \$10,000 of qualified reforestation expenses for each qualifying timber property. The corporation can elect to amortize over 84 months any amount not deducted.

- Insurance premiums.
- Legal and professional fees.
- Supplies used and consumed in the business.
- Travel, meals, and entertainment expenses.
- Utilities.
- Ordinary losses from trade or business activities of a partnership (from Schedule K-1 (Form 1065 or 1065-B)). Do not offset ordinary income against ordinary losses. Instead, include the income on line 10. Show the partnership's name, address, and EIN on a separate statement attached to this return. If the amount is from more than one partnership, identify the amount from each partnership.
- Any extraterritorial income exclusion (from Form 8873, line 52).
- Any negative net section 481(a) adjustment. See the instructions for line 10.
- Deduction for certain energy efficient commercial building property placed in service during the tax year. See section 179D.
- Dividends paid in cash on stock held by an employee stock ownership plan. However, a deduction can only be taken for the dividends above if, according to the plan, the dividends are:
 1. Paid in cash directly to the plan participants or beneficiaries;
 2. Paid to the plan, which distributes them in cash to the plan participants or their beneficiaries no later than 90 days after the end of the plan year in which the dividends are paid;
 3. At the election of such participants or their beneficiaries (a) payable as provided under 1 or 2 above or (b) paid to the plan and reinvested in qualifying employer securities; or
 4. Used to make payments on a loan described in section 404(a)(9).

See section 404(k) for more details and the limitation on certain dividends.

Do not deduct the following.

- Fines or penalties paid to a government for violating any law.
- Any amount that is allocable to a class of exempt income. See section 265(b) for exceptions.
- Lobbying expenses. However, see exceptions (discussed later).

Travel, meals, and entertainment. Subject to limitations and restrictions discussed below, a corporation can deduct ordinary and necessary travel, meals, and entertainment expenses paid or incurred in its trade or business. Also, special rules apply to deductions for gifts, skybox rentals, luxury water travel, convention expenses, and entertainment tickets. See section 274 and Pub. 463 for more details.

Travel. The corporation cannot deduct travel expenses of any individual accompanying a corporate officer or employee, including a spouse or dependent of the officer or employee, unless:

- That individual is an employee of the corporation, and
- His or her travel is for a bona fide business purpose and would otherwise be deductible by that individual.

Meals and entertainment. Generally, the corporation can deduct only 50% of the amount otherwise allowable for meals and entertainment expenses paid or incurred in its trade or business. In addition (subject to exceptions under section 274(k)(2)):

- Meals must not be lavish or extravagant;
- A bona fide business discussion must occur during, immediately before, or immediately after the meal; and
- An employee of the corporation must be present at the meal.

See section 274(n)(3) for a special rule that applies to expenses for meals consumed by individuals subject to the hours of service limits of the Department of Transportation.

Membership dues. The corporation can deduct amounts paid or incurred for membership dues in civic or public service organizations, professional organizations (such as bar and medical associations), business leagues, trade associations, chambers of commerce, boards of trade, and real estate boards. However, no deduction is allowed if a principal purpose of the organization is to entertain, or provide entertainment facilities for, members or their guests. In addition, corporations cannot deduct membership dues in any club organized for business, pleasure, recreation, or other social purpose. This includes country clubs, golf and athletic clubs, airline and hotel clubs, and clubs operated to provide meals under conditions favorable to business discussion.

Entertainment facilities. The corporation cannot deduct an expense paid or incurred for a facility (such as a yacht or hunting lodge) used for an activity usually considered entertainment, amusement, or recreation.

Amounts treated as compensation. Generally, the corporation may be able to deduct otherwise nondeductible meals, travel, and entertainment expenses if the amounts are treated as compensation to the recipient and reported on Form W-2 for an employee or on Form 1099-MISC for an independent contractor.

However, if the recipient is an officer, director, or beneficial owner (directly or indirectly) of more than 10% of any class of stock, the deductible expense is limited.

Lobbying expenses. Generally, lobbying expenses are not deductible. These expenses include:

- Amounts paid or incurred in connection with influencing federal or state legislation (but not local legislation) or
- Amounts paid or incurred in connection with any communication with certain federal executive branch officials in an attempt to influence the official actions or positions of the officials. See Regulations section 1.162-29 for the definition of “influencing legislation.”

Dues and other similar amounts paid to certain tax-exempt organizations may not be deductible. If certain in-house lobbying expenditures do not exceed \$2,000, they are deductible.

Line 28. Taxable Income Before NOL Deduction and Special Deductions

At-risk rules. Generally, special at-risk rules under section 465 apply to closely held corporations engaged in any activity as a trade or business or for the production of income. These corporations may have to adjust the amount on line 28. (See below.)

The at-risk rules do not apply to:

- Holding real property placed in service by the taxpayer before 1987;
- Equipment leasing under sections 465(c)(4), (5), and (6); or
- Any qualifying business of a qualified corporation under section 465(c)(7).

However, the at-risk rules do apply to the holding of mineral property.

If the at-risk rules apply, adjust the amount on this line for any section 465(d) losses. These losses are limited to the amount for which the corporation is at risk for each separate activity at the close of the tax year. If the corporation is involved in one or more activities, any of which incurs a loss for the year, report the losses for each activity separately. Attach Form 6198, At-Risk Limitations, showing the amount at risk and gross income and deductions for the activities with the losses.

If the corporation sells or otherwise disposes of an asset or its interest (either total or partial) in an activity to which the at-risk rules apply, determine the net profit or loss from the activity by combining the gain or loss on the sale or disposition with the profit or loss from the activity. If the corporation has a net loss, it may be limited because of the at-risk rules.

Treat any loss from an activity not allowed for the tax year as a deduction allocable to the activity in the next tax year.

Line 29a. Net Operating Loss Deduction

A corporation can use the NOL incurred in one tax year to reduce its taxable income in another tax year. Enter on line 29a, the total NOL carryovers from other tax years, but do not enter more than the corporation's taxable income (after special deductions). Attach a schedule showing the computation of the NOL deduction. Complete item 12 on Schedule K.

The following special rules apply.

- A personal service corporation may not carry back an NOL to or from any tax year to which an election under section 444 to have a tax year other than a required tax year applies.
- A corporate equity reduction interest loss may not be carried back to a tax year preceding the year of the equity reduction transaction (see section 172(b)(1)(E)).
- If an ownership change occurs, the amount of the taxable income of a loss corporation that may be offset by the pre-change NOL carryovers may be limited. See section 382 and the related regulations. A loss corporation must include the information statement as provided in Temporary Regulations section 1.382-11T(a), with its income tax return for each tax year that certain ownership shifts described in Temporary Regulations section 1.382-2T(a)(2)(i) occur. If the corporation makes the closing-of-the-books election, see Regulations section 1.382-6(b).

The limitations under section 382 do not apply to certain ownership changes after February 17, 2009, made pursuant to a restructuring plan under the Emergency Economic Stabilization Act of 2008. See section 382 (n).

For guidance in applying section 382 to loss corporations whose instruments were acquired by Treasury under certain programs under the Emergency Economic Stabilization Act of 2008, see Notice 2009-38, 2009-18 I.R.B. 901.

- If a corporation acquires control of another corporation (or acquires its assets in a reorganization), the amount of pre-acquisition losses that may offset recognized built-in gain may be limited (see section 384).
- If a corporation elects the alternative tax on qualifying shipping activities under section 1354, no deduction is allowed for an NOL attributable to the qualifying shipping activities to the extent that the loss is carried forward from a tax year preceding the first tax year for which the alternative tax election was made. See section 1358(b)(2).
- If a corporation has a loss attributable to a disaster, special rules apply. See the Instructions for Form 1139.

Line 29b. Special Deductions

See the instructions for Schedule C.

Tax and Payments

Line 30. Taxable Income

Minimum taxable income. The corporation's taxable income cannot be less than the largest of the following amounts.

- The inversion gain of the corporation for the tax year, if the corporation is an expatriated entity or a partner in an expatriated entity. For details, see section 7874.
- The sum of the corporation's excess inclusions from Schedules Q (1066), line 2c, and the corporation's taxable income determined solely with respect to its ownership and high-yield interests in FASITs. For details, see sections 860E(a) and 860J.

Net operating loss (NOL). If line 30 (figured without regard to the **minimum taxable income** rule stated above) is zero or less, the corporation may have an NOL that can be carried back or forward as a deduction to other tax years. Generally, a corporation first carries back an NOL 2 tax years. However, the corporation can elect to waive the carryback period and instead carry the NOL forward to future tax years. See the instructions for Schedule K, Item 11.

Special rules and exceptions to the 2-year carryback period apply to certain NOLs. See the instructions for Form 1139 for details on these special rules and other elections that may be available, which must be made no later than 6 months after the due date (excluding extensions) of the corporation's tax return.

Merchant Marine capital construction fund. To take a deduction for amounts contributed to a capital construction fund (CCF), reduce the amount that would otherwise be entered on line 30 by the amount of the deduction. On the dotted line next to the entry space, enter "CCF" and the amount of the deduction. For more information, see section 7518.

Line 32b. Estimated Tax Payments

Enter any estimated tax payments the corporation made for the tax year.

Beneficiaries of trusts. If the corporation is the beneficiary of a trust, and the trust makes a section 643(g) election to credit its estimated tax payments to its beneficiaries, include the corporation's share of the payment in the total for line 32b. Enter "T" and the amount on the dotted line next to the entry space.

Special estimated tax payments for certain life insurance companies. If the corporation is required to make or apply special estimated tax payments (SETP) under section 847 in addition to its regular estimated tax payments, enter on line 32b the corporation's total estimated tax payments. In the margin near line 32b, enter "Form 8816" and the amount. Attach a schedule showing your computation of estimated tax payments. See sections 847(2) and 847(8) and Form 8816, Special Loss Discount Account and Special Estimated Tax Payments for Insurance Companies, for more information.

Line 32c. Overpaid estimated tax

If the corporation overpaid estimated tax, it may be able to get a quick refund by filing Form 4466. The overpayment must be at least 10% of the corporation's expected income tax liability and at least \$500. File Form 4466 after the end of the corporation's tax year, and no later than the 15th day of the third month after the end of the tax year. Form 4466 must be filed before the corporation files its tax return.

Line 32f.

Credit from Form 2439. Enter the credit from Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains for the corporation's share of the tax paid by a regulated investment company (RIC) or a real estate investment trust (REIT) on undistributed long-term capital gains included in the corporation's income. Attach Form 2439 to Form 1120.

Credit for federal tax on fuels. Enter any credit from Form 4136, Credit for Federal Tax Paid on Fuels. Attach Form 4136 to Form 1120.

Credit for tax on ozone-depleting chemicals. Include on line 32f any credit the corporation is claiming under section 4682(g)(2) for tax on ozone-depleting chemicals. Enter "ODC" next to the entry space.

Line 32g. Refundable Credits From Forms 3800 and 8827

If the corporation elected to claim certain unused research or minimum tax credits instead of claiming any additional first-year special depreciation allowance for eligible

property, see the instructions for Forms 3800 and 8827. Enter on line 32g the amounts from line 19c of Form 3800 and line 8c of Form 8827, if applicable. See the instructions for these forms.

Line 32h. Total Payments

Add the amounts on lines 32d through 32g and enter the total on line 32h.

Backup withholding. If the corporation had federal income tax withheld from any payments it received because, for example, it failed to give the payer its correct EIN, include the amount withheld in the total for line 32h. Enter the amount withheld and the words "Backup Withholding" in the blank space above line 32h.

Line 33. Estimated Tax Penalty

If Form 2220 is attached, check the box on line 33, and enter the amount of any penalty on this line.

Line 36

Direct Deposit of Refund. If the corporation wants its refund directly deposited into its checking or savings account at any U.S. bank or other financial institution instead of having a check sent to the corporation, complete Form 8050 and attach it to the corporation's tax return.

Schedule A. Cost of Goods Sold

Generally, inventories are required at the beginning and end of each tax year if the production, purchase, or sale of merchandise is an income-producing factor.

However, if the corporation is a qualifying taxpayer or a qualifying small business taxpayer, it can adopt or change its accounting method to account for inventoriable items in the same manner as materials and supplies that are not incidental unless its business is a tax shelter as defined in section 448(d)(3).

A qualifying taxpayer is a taxpayer that, for each prior tax year ending after December 16, 1998, has average annual gross receipts of \$1 million or less for the 3 prior tax years.

A qualifying small business taxpayer is a taxpayer (a) that, for each prior tax year ending on or after December 31, 2000, has average annual gross receipts of \$10 million or less for the 3 prior tax years and (b) whose principal business activity is not an ineligible activity.

Under this accounting method, inventory costs for raw materials purchased for use in producing finished goods and merchandise purchased for resale are deductible in the year the finished goods or merchandise are sold (but not before the year the corporation paid for the raw materials or merchandise, if it is also using the cash method).

Corporations that account for inventoriable items in the same manner as materials and supplies that are not incidental can currently deduct expenditures for direct labor and all indirect costs that would otherwise be included in inventory costs.

Enter amounts paid for all raw materials and merchandise during the tax year on line 2. The amount the corporation can deduct for the tax year is figured on line 8.

All filers not using the cash method of accounting should see *Section 263A uniform capitalization rules* before completing Schedule A.

Line 1. Inventory at Beginning of Year

If the corporation is changing its method of accounting for the current tax year, it must refigure last year's closing inventory using its new method of accounting and enter the result on line 1. If there is a difference between last year's closing inventory and the refigured amount, attach an explanation and take it into account when figuring the corporation's section 481(a) adjustment.

Line 4. Additional Section 263A Costs

An entry is required on this line only for corporations that have elected a simplified method of accounting.

For corporations that have elected the simplified production method, additional section 263A costs are generally those costs, other than interest, that were not capitalized under the corporation's method of accounting immediately prior to the effective date of section 263A but are now required to be capitalized under section 263A.

For corporations that have elected the simplified resale method, additional section 263A costs are generally those costs incurred with respect to the following categories.

- Off-site storage or warehousing.
- Purchasing.
- Handling, such as processing, assembling, repackaging, and transporting.
- General and administrative costs (mixed service costs).

Enter on line 4 the balance of section 263A costs paid or incurred during the tax year not includible on lines 2, 3, and 5.

Line 5. Other Costs

Enter on line 5 any costs paid or incurred during the tax year not entered on lines 2 through 4.

Line 7. Inventory at End of Year

See Regulations sections 1.263A-1 through 1.263A-3 for details on figuring the amount of additional section 263A costs to be included in ending inventory. If the corporation accounts for inventoriable items in the same manner as materials and supplies that are not incidental, enter on line 7 the portion of its raw materials and merchandise purchased for resale that is included on line 6 and was not sold during the year.

Lines 9a Through 9f. Inventory Valuation Methods

Inventories can be valued at:

- Cost;
- Cost or market value (whichever is lower); or
- Any other method approved by the IRS that conforms to the requirements of the applicable regulations.

However, if the corporation is using the cash method of accounting, it is required to use cost.

Generally, a rolling average method that is used to value inventories for financial accounting purposes does not clearly reflect income for federal income tax purposes. However, if a corporation uses the average cost method for financial accounting purposes, there are two safe harbors under which this method will be deemed to clearly reflect income for federal income tax purposes.

Corporations that use erroneous valuation methods must change to a method permitted for federal income tax purposes. Use Form 3115 to make this change.

On line 9a, check the method(s) used for valuing inventories. Under lower of cost or market, the term “market” (for normal goods) means the current bid price prevailing on the inventory valuation date for the particular merchandise in the volume usually purchased by the taxpayer. For a manufacturer, market applies to the basic elements of cost – raw materials, labor, and burden. If section 263A applies to the taxpayer, the basic elements of cost must reflect the current bid price of all direct costs and all indirect costs properly allocable to goods on hand at the inventory date.

Inventory may be valued below cost when the merchandise is unsalable at normal prices or unusable in the normal way because the goods are subnormal due to damage, imperfections, shopwear, etc., within the meaning of Regulations section 1.471-2(c). The goods may be valued at the bona fide selling price, minus direct cost of disposition (but not less than scrap value). Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date.

If this is the first year the Last-in, First-out (LIFO) inventory method was either adopted or extended to inventory goods not previously valued under the LIFO method provided in section 472, attach Form 970, Application To Use LIFO Inventory Method, or a statement with the information required by Form 970. Also check the LIFO box on line 9c. On line 9d, enter the amount or the percent of total closing inventories covered under section 472. Estimates are acceptable.

If the corporation changed or extended its inventory method to LIFO and had to write up the opening inventory to cost in the year of election, report the effect of the write-up as other income (line 10, page 1), proportionately over a 3-year period that begins with the year of the LIFO election (section 472(d)).

Note. Corporations using the LIFO method that make an S corporation election or transfer LIFO inventory to an S corporation in a nonrecognition transaction may be subject to an additional tax attributable to the LIFO recapture amount. See the instructions for line 10, Schedule J, and line 10, *Other Income*.

Schedule C. Dividends and Special Deductions

For purposes of the 20% ownership test on lines 1 through 7, the percentage of stock owned by the corporation is based on voting power and value of the stock. Preferred stock described in section 1504(a)(4) is not taken into account.

Corporations filing a consolidated return must not report as dividends on Schedule C any amounts received from corporations within the tax consolidation group. Such dividends are eliminated in consolidation rather than offset by the dividends-received deduction.

Line 1, Column (a)

Enter dividends (except those received on debt-financed stock acquired after July 18, 1984 – see section 246A) that are:

- Received from less-than-20%-owned domestic corporations subject to income tax and
- Qualified for the 70% deduction under section 243(a)(1).

Also include on line 1 the following:

- Taxable distributions from an IC-DISC or former DISC that are designated as eligible for the 70% deduction and certain dividends of Federal Home Loan Banks. See section 246(a)(2).
- Dividends (except those received on debt-financed stock acquired after July 18, 1984) from a regulated investment company (RIC). The amount of dividends eligible for the dividends-received deduction under section 243 is limited by section 854(b). The corporation should receive a notice from the RIC specifying the amount of dividends that qualify for the deduction.

Report so-called dividends or earnings received from mutual savings banks, etc., as interest. Do not treat them as dividends.

Line 2, Column (a)

Enter on line 2:

- Dividends (except those received on debt-financed stock acquired after July 18, 1984) that are received from 20%-or-more-owned domestic corporations subject to income tax and that are subject to the 80% deduction under section 243(c) and
- Taxable distributions from an IC-DISC or former DISC that are considered eligible for the 80% deduction.

Line 3, Column (a)

Enter the following:

- Dividends received on debt-financed stock acquired after July 18, 1984, from domestic and foreign corporations subject to income tax that would otherwise be subject to the dividends-received deduction under section 243(a)(1), 243(c), or 245(a). Generally, debt-financed stock is stock that the corporation acquired by incurring a debt (for example, it borrowed money to buy the stock).
- Dividends received from a RIC on debt-financed stock. The amount of dividends eligible for the dividends-received deduction is limited by section 854(b). The corporation should receive a notice from the RIC specifying the amount of dividends that qualify for the deduction.

Line 3, Columns (b) and (c)

Dividends received on debt-financed stock acquired after July 18, 1984, are not entitled to the full 70% or 80% dividends-received deduction. The 70% or 80% deduction is reduced by a percentage that is related to the amount of debt incurred to acquire the stock. See section 246A. Also see section 245(a) before making this computation for an additional limitation that applies to dividends received from foreign corporations. Attach a schedule to Form 1120 showing how the amount on line 3, column (c), was figured.

Line 4, Column (a)

Enter dividends received on preferred stock of a less-than-20%-owned public utility that is subject to income tax and is allowed the deduction provided in section 247 for dividends paid.

Line 5, Column (a)

Enter dividends received on preferred stock of a 20%-or-more-owned public utility that is subject to income tax and is allowed the deduction provided in section 247 for dividends paid.

Line 6, Column (a)

Enter the U.S.-source portion of dividends that:

- Are received from less-than-20%-owned foreign corporations, and
- Qualify for the 70% deduction under section 245(a). To qualify for the 70% deduction, the corporation must own at least 10% of the stock of the foreign corporation by vote and value.

Also include dividends received from a less-than-20%-owned FSC that:

- Are attributable to income treated as effectively connected with the conduct of a trade or business within the United States (excluding foreign trade income), and
- Qualify for the 70% deduction under section 245(c)(1)(B).

Line 7, Column (a)

Enter the U.S.-source portion of dividends that:

- Are received from 20%-or-more-owned foreign corporations, and
- Qualify for the 80% deduction under section 245(a).

Also include dividends received from a 20%-or-more-owned FSC that:

- Are attributable to income treated as effectively connected with the conduct of a trade or business within the United States (excluding foreign trade income), and
- Qualify for the 80% deduction under section 245(c)(1)(B).

Line 8, Column (a)

Enter dividends received from wholly owned foreign subsidiaries that are eligible for the 100% deduction under section 245(b).

In general, the deduction under section 245(b) applies to dividends paid out of the earnings and profits of a foreign corporation for a tax year during which:

- All of its outstanding stock is directly or indirectly owned by the domestic corporation receiving the dividends, and
- All of its gross income from all sources is effectively connected with the conduct of a trade or business within the United States.

Line 9, Column (c)

Generally, line 9, column (c), cannot exceed the amount from the worksheet below. However, in a year in which a NOL occurs, this limitation does not apply even if the loss is created by the dividends-received deduction. See sections 172(d) and 246(b).

Worksheet for Schedule C, line 9	
<i>Keep for your records</i>	
1. Refigure line 28, page 1, Form 1120, without any domestic production activities deduction, any adjustment under section 1059, and without any capital loss carryback to the tax year under section 1212(a)(1).	1. _____
2. Complete lines 10, 11, and 12, column (c), and enter the total here.	2. _____
3. Subtract line 2 from line 1.	3. _____
4. Multiple line 3 by 80%.	4. _____
5. Add lines, 2, 5, 7, and 8, column (c), and the part of the deduction on line 3, column (c) that is attributable to dividends from 20%-or-more-owned corporations.	5. _____
6. Enter the smaller of line 4 or 5. If line 5 is greater than line 4, stop here; enter the amount from line 6 on line 9, column (c), and do not complete the rest of this worksheet.	6. _____
7. Enter the total amount of dividends from 20%-or-more-owned corporations that are included on lines 2, 3, 5, 7, and 8, column (a)	7. _____
8. Subtract line 7 from line 3.	8. _____
9. Multiply line 8 by 70%.	9. _____
10. Subtract line 5 above from line 9, column (c).	10. _____
11. Enter the smaller of line 9 or line 10.	11. _____
12. Dividends-received deduction after limitation (sec. 246(b)).	12. _____
Add lines 6 and 11. Enter the result here and on line 9, column (c).	12. _____

Line 10, Columns (a) and (c)

Small business investment companies operating under the Small Business Investment Act of 1958 (see 15 U.S.C. 661 and following) must enter dividends that are received from domestic corporations subject to income tax even though a deduction is allowed for the entire amount of those dividends. To claim the 100% deduction on line 10, column (c), the company must file with its return a statement that it was a federal licensee under the Small Business Investment Act of 1958 at the time it received the dividends.

Line 11, Columns (a) and (c)

Enter only dividends that qualify under section 243(b) for the 100% dividends-received deduction described in section 243(a)(3). Corporations taking this deduction are subject to the provisions of section 1561.

The 100% deduction does not apply to affiliated group members that are joining in the filing of a consolidated return.

Line 12, Column (a)

Enter dividends from FSCs that are attributable to foreign trade income and that are eligible for the 100% deduction provided in section 245(c)(1)(A).

Line 13, Column (a)

Enter foreign dividends not reportable on lines 3, 6, 7, 8, 11 or 12 of column (a). Include on line 13 the corporation's share of the ordinary earnings of a qualified electing fund from line 1c of Form 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualifying Electing Fund. Exclude distributions of amounts constructively taxed in the current year or in prior years under subpart F (sections 951 through 964).

Line 14, Column (a)

Include income constructively received from CFCs under subpart F. This amount should equal the total subpart F income reported on Schedule I, Form 5471.

Line 15, Column (a)

Include gross-up for taxes deemed paid under section 902 and 960.

Line 16, Column (a)

Enter taxable distributions from an IC-DISC or former DISC that are designated as not eligible for a dividends-received deduction.

No deduction is allowed under section 243 for a dividend from an IC-DISC or former DISC (as defined in section 922(a)) to the extent the dividend:

- Is paid out of the corporation's accumulated IC-DISC income or previously taxed income, or
- Is a deemed distribution under section 995(b)(1).

Line 17, Column (a)

Include the following:

1. Dividends (other than capital gain distributions reported on Schedule D (Form 1120) and exempt-interest dividends) that are received from RICs and that are not subject to the 70% deduction.
2. Dividends from tax-exempt organizations.
3. Dividends (other than capital gain distributions) received from a REIT that, for the tax year of the trust in which the dividends are paid, qualifies under sections 856 through 860.
4. Dividends not eligible for a dividends-received deduction, which include the following.
 - a. Dividends received on any share of stock held for less than 46 days during the 91-day period beginning 45 days before the ex-dividend date. When counting the number of days the corporation held the stock, you cannot count certain days during which the corporation's risk of loss was diminished.
 - b. Dividends attributable to periods totaling more than 366 days that the corporation received on any share of preferred stock held for less than 91 days during the 181-day period that began 90 days before the ex-dividend date. When counting the number of days the corporation held the stock, you cannot count certain days during which the corporation's risk of loss was diminished.
 - c. Dividends on any share of stock to the extent the corporation is under an obligation (including a short sale) to make related payments with respect to positions in substantially similar or related property.
5. Any other taxable dividend income not properly reported elsewhere on Schedule C.

If patronage dividends or per-unit retain allocations are included on line 17, identify the total of these amounts in a schedule attached to Form 1120.

Line 18, Column (c)

Section 247 allows public utilities a deduction of 40% of the smaller of (a) dividends paid on their preferred stock during the tax year or (b) taxable income computed without regard to this deduction. In a year in which an NOL occurs, compute the deduction without regard to section 247(a)(1)(B). See section 172(d).

Schedule J. Tax Computation

Line 1

If a corporation is a member of a controlled group, check the box on line 1. Complete and attach Schedule O (Form 1120), Consent Plan and Apportionment Schedule for a Controller Group. Component members of a controlled group must use Schedule O to report the apportionment of taxable income, income tax, and certain tax benefits between the members of the group. See Schedule O and its instructions for more information.

Line 2

If the corporation is a member of a controlled group and is filing Schedule O (Form 1120), enter the corporation's tax from Part III of Schedule O (Form 1120). Most corporations that are not members of a controlled group and not filing a consolidated return figure their tax by using the Tax Rate Schedule below. Qualified personal service corporations should see the instructions later.

Tax Rate Schedule			
If taxable income (line 30, Form 1120) on page 1 is:			
Over...	But not over...	Tax is:	Of the amount over...
\$0	\$50,000	15%	\$0
50,000	75,000	\$7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	-----	35%	0

Qualified personal service corporation. A qualified personal service corporation is taxed at a flat rate of 35% on taxable income. If the corporation is a qualified personal service corporation, check the box on line 2 even if the corporation has no tax liability.

A corporation is a qualified personal service corporation if it meets both of the following tests.

1. Substantially all of the corporation's activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.
2. At least 95% of the corporation's stock, by value, is directly or indirectly owned by
 - a. Employees performing the services,
 - b. Retired employees who had performed the services listed above,
 - c. Any estate of an employee or retiree described above, or
 - d. Any person who acquired the stock of the corporation as a result of the death of an employee or retiree (but only for the 2-year period beginning on the date of the employee's or retiree's death).

Line 3

Caution. A corporation that is not a small corporation exempt from the AMT (see below) may be required to file Form 4626 if it claims certain credits, even though it does not owe any AMT. See Form 4626 for details.

Unless the corporation is treated as a small corporation exempt from the AMT, it may owe the AMT if it has any of the adjustments and tax preference items listed on Form 4626. The corporation must file Form 4626 if its taxable income (or loss) before the NOL deduction, combined with these adjustments and tax preference items is more than the smaller of \$40,000 or the corporation's allowable exemption amount (from Form 4626). For this purpose, taxable income does not include the NOL deduction. See Form 4626 for details.

Line 5a

To find out when a corporation can take the credit for payment of income tax to a foreign country or U.S. possession, see Form 1118, Foreign Tax Credit – Corporations.

Line 5b

Enter any qualified electric vehicle passive activity credits from prior years allowed for the current tax year from Form 8834, Qualified Plug-in Electric and Electric Vehicle Credit, line 29. Also include on line 5b any credits from Form 5735, American Samoa Economic Development Credit. See the Instructions for Form 5735.

Line 5c

Enter on line 5c the allowable credit from Form 3800, Part II, line 32.

The corporation is required to file Form 3800, General Business Credit, to claim most business credits. For a list of allowable credits, see Form 3800. Also, see the applicable credit form and its instructions.

Line 5d

To figure the minimum tax credit and any carryforward of that credit, use Form 8827, Credit for Prior Year Minimum Tax – Corporations.

Line 5e

Enter the allowable credits from Form 8912, Credit to Holders of Tax Credit Bonds, line 18.

Line 8

A corporation is taxed as a personal holding company under section 542 if:

- At least 60% of its adjusted ordinary gross income for the tax year is personal holding company income, and
- At any time during the last half of the tax year more than 50% in value of its outstanding stock is directly or indirectly owned by five or fewer individuals.

Line 9

Include any of the following taxes and interest in the total on line 9. Check the appropriate box(es) for the form, if any, used to compute the total.

Recapture of investment credit. If the corporation disposed of investment credit property or changed its use before the end of its useful life or recovery period, or is required to recapture a qualifying therapeutic discovery project grant, enter the increase in tax from Form 4255, Recapture of Investment Credit.

Recapture of low-income housing credit. If the corporation disposed of property (or there was a reduction in the qualified basis of the property) for which it took the low-income housing credit, it may owe a tax. See Form 8611, Recapture of Low-Income Housing Credit.

Interest due under the look-back methods. If the corporation used the look-back method for certain long-term contracts, see Form 8697, Interest Computation Under the Look-Back Method for Completed Long-Term Contracts, for information on figuring the interest the corporation may have to include.

The corporation may also have to include interest due under the look-back method for property depreciated under the income forecast method. See Form 8866, Interest Computation Under the Look-Back Method for Property Depreciated Under the Income Forecast Method.

Alternative tax on qualifying shipping activities. Enter any alternative tax on qualifying shipping activities from Form 8902. Check the box for Form 8902.

Other. Additional taxes and interest amounts can be included in the total entered on line 9. Check the box for "Other" if the corporation includes any additional taxes and interest.

- Recapture of Indian employment credit. Generally, if an employer terminates the employment of a qualified employee less than 1 year after the date of initial employment, any Indian employment credit allowed for a prior tax year because of wages paid or incurred to that employee must be recaptured. For details, see Form 8845 and section 45A.
- Recapture of new markets credit (see Form 8874).
- Recapture of employer-provided childcare facilities and services credit (see Form 8882).
- Tax and interest on a nonqualified withdrawal from a capital construction fund (section 7518(g)).
- Interest on deferred tax attributable to:
 - (a) installment sales of certain timeshares and residential lots (section 453(l)(3)), and
 - (b) certain nondealer installment obligations (section 453A(c)).
- Interest due on deferred gain (section 1260(b)).

Line 10

Include any deferred tax on the termination of a section 1294 election applicable to shareholders in a qualified electing fund in the amount entered on line 10.

Subtract the following amounts from the total for line 10.

- Deferred tax on the corporation's share of undistributed earnings of a qualified electing fund (see Form 8621, Part II).
- Deferred LIFO recapture tax (section 1363(d)).

Step 1. Figure the tax on the corporation's income including the LIFO recapture amount. (Complete Schedule J through line 9, but do not enter a total on line 10 yet.)

Step 2. Using a separate worksheet, complete Schedule J again, but do not include the LIFO recapture amount in the corporation's taxable income.

Step 3. Compare the tax in Step 2 to the tax in Step 1. (The difference between the two is the LIFO recapture tax.)

Step 4. Multiply the amount figured in Step 3 by 75%. (The result is the deferred LIFO recapture tax.)

Schedule K. Other Information

Complete all the items that apply to the corporation.

Question 3

Check the "Yes" box for question 3 if:

- The corporation is a subsidiary in an affiliated group, but is not filing a consolidated return for the tax year with that group, or
- The corporation is a subsidiary in a parent-subsiidiary controlled group.

Any corporation that meets either of the requirements above should check the "Yes" box. This applies even if the corporation is a subsidiary member of one group and the parent corporation of another.

Note. If the corporation is an "excluded member" of a controlled group (see section 1563(b)(2)), it is still considered a member of a controlled group for this purpose.

Question 7

Check the "Yes" box if one foreign person owned at least 25% of (a) the total voting power of all classes of stock of the corporation entitled to vote or (b) the total value of all classes of stock of the corporation.

The constructive ownership rules of section 318 apply in determining if a corporation is foreign owned. See section 6038A(c)(5) and the related regulations.

Enter on line 7a the percentage owned by the foreign person specified in question 7. On line 7b, enter the name of the owner's country.

Note. If there is more than one 25%-or-more foreign owner, complete lines 7a and 7b for the foreign person with the highest percentage of ownership.

Foreign person. The term “foreign person” means:

- A foreign citizen or nonresident alien,
- An individual who is a citizen of a U.S. possession (but who is not a U.S. citizen or resident),
- A foreign partnership,
- A foreign corporation,
- Any foreign estate or trust within the meaning of section 7701(a)(31), or
- A foreign government (or one of its agencies or instrumentalities) to the extent that it is engaged in the conduct of a commercial activity as described in section 892.

Owner’s country. For individuals, the term “owner’s country” means the country of residence. For all others, it is the country where incorporated, organized, created, or administered.

Requirement to file Form 5472. If the corporation checked “Yes,” it may have to file Form 5472, Information Return of a 25% Foreign Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Generally, a 25% foreign-owned corporation that had a reportable transaction with a foreign or domestic related party during the tax year must file Form 5472. See Form 5472 for filing instructions and penalties for failure to file.

Item 9

Show any tax-exempt interest received or accrued. Including any exempt-interest dividends received as a shareholder in a mutual fund or other RIC. Also, if required, include the same amount on Schedule M-1, line 7 (or Schedule M-3, Part II, line 13, if applicable).

Item 11

If the corporation has an NOL, it generally can elect to waive the entire carryback period for the NOL and instead carry the NOL forward to future tax years. To do so, check the box on line 11 and file the tax return by its due date, including extensions (do not attach the statement described in Temporary Regulations section 301.9100-12T). Once made, the election is irrevocable.

Corporations filing a consolidated return must also attach the statement required by Regulations section 1.1502-21(b)(3) or the election will not be valid.

Item 12

Enter the amount of the NOL carryover to the tax year from prior years, even if some of the loss is used to offset income on this return. The amount to enter is the total of all NOLs generated in prior years but not used to offset income (either as a carryback or carryover) to a tax year prior to 2010. Do not reduce the amount by any NOL deduction reported on line 29a.

Schedule L. Balance Sheet per Books

The balance sheet should agree with the corporation's books and records.

Corporations with total receipts (line 1a plus lines 4 through 10 on page 1) and total assets at the end of the tax year less than \$250,000 are not required to complete Schedules L, M-1, and M-2 if the "Yes" box on Schedule K, question 13 is checked. If the corporation is required to complete Schedule L, include total assets reported on Schedule L, line 15, column (d), on page 1, item D.

Corporations with total assets non-consolidated (or consolidated for all corporations included within the tax consolidation group) of \$10 million or more on the last day of the tax year must complete Schedule M-3 (Form 1120) instead of Schedule M-1. See the separate instructions for Schedule M-3 (Form 1120) for provisions also affecting Schedule L.

If filing a consolidated return, report total consolidated assets, liabilities, and shareholder's equity for all corporations joining in the return.

Line 1

Include certificates of deposit as cash on this line.

Line 5

Include on this line:

- State and local government obligations, the interest on which is excludable from gross income under section 103(a) and
- Stock in a mutual fund or other RIC that distributed exempt-interest dividends during the tax year of the corporation.

Line 26

Some examples of adjustments to report on this line include:

- Unrealized gains and losses on securities held "available for sale."
- Foreign currency translation adjustments.
- The excess of additional pension liability over unrecognized prior service cost.
- Guarantees of employee stock (ESOP) debt.
- Compensation related to employee stock award plans.

If the total adjustment to be entered on line 26 is a negative amount, enter the amount in parentheses.

Schedule M-1. Reconciliation of Income (Loss) per Books With Income per Return

Corporations with total receipts (line 1a plus lines 4 through 10 on page 1) and total assets at the end of the tax year less than \$250,000 are not required to complete Schedules L, M-1, and M-2 if the "Yes" box on Schedule K, question 13 is checked.

Corporations with total assets non-consolidated (or consolidated for all corporations included within the tax consolidation group) of \$10 million or more on the last day of the tax year must complete Schedule M-3 (Form 1120) instead of Schedule M-1. A corporation filing Form 1120 that is not required to file Schedule M-3 may voluntarily file Schedule M-3 instead of Schedule M-1. See the Instructions for Schedule M-3 (Form 1120) for more information.

Line 5c

Include any of the following.

- Meal and entertainment expenses not deductible under section 274(n).
- Expenses for the use of an entertainment facility.
- The part of business gifts over \$25.
- Expenses of an individual over \$2,000, which are allocable to conventions on cruise ships.
- Employee achievement awards over \$400.
- The cost of entertainment tickets over face value (also subject to 50% limit under section 274(n)).
- The cost of skyboxes over the face value of nonluxury box seat tickets.
- The part of luxury water travel expenses not deductible under section 274(m).
- Expenses for travel as a form of education.
- Other nondeductible travel and entertainment expenses.

Line 7

Report any tax exempt interest received or accrued, including any exempt-interest dividends received as a shareholder in a mutual fund or other RIC. Also report this same amount on Schedule K, item 9.

A Check if: 1a Consolidated return (attach Form 851) <input type="checkbox"/> b Life/nonlife consolidated return <input type="checkbox"/> 2 Personal holding co. (attach Sch. PH) <input type="checkbox"/> 3 Personal service corp. (see instructions) <input type="checkbox"/> 4 Schedule M-3 attached <input type="checkbox"/>	<table border="1" style="width:100%; border-collapse: collapse;"> <tr> <td style="width:20%;">Name</td> <td>_____</td> </tr> <tr> <td>Number, street, and room or suite no. If a P.O. box, see instructions.</td> <td>_____</td> </tr> <tr> <td>City or town, state, and ZIP code</td> <td>_____</td> </tr> </table>	Name	_____	Number, street, and room or suite no. If a P.O. box, see instructions.	_____	City or town, state, and ZIP code	_____	B Employer identification number _____ C Date incorporated _____ D Total assets (see instructions) \$ _____ E Check if: (1) <input type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Name change (4) <input type="checkbox"/> Address change
Name	_____							
Number, street, and room or suite no. If a P.O. box, see instructions.	_____							
City or town, state, and ZIP code	_____							

Income	1a	Gross receipts or sales		b	Less returns and allowances		c	Bal ▶		1c			
	2	Cost of goods sold (Schedule A, line 8)								2			
	3	Gross profit. Subtract line 2 from line 1c								3			
	4	Dividends (Schedule C, line 19)								4			
	5	Interest								5			
	6	Gross rents								6			
	7	Gross royalties								7			
	8	Capital gain net income (attach Schedule D (Form 1120))								8			
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)								9			
	10	Other income (see instructions—attach schedule)								10			
	11	Total income. Add lines 3 through 10								▶	11		
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (Schedule E, line 4)								▶	12		
	13	Salaries and wages (less employment credits)									13		
	14	Repairs and maintenance									14		
	15	Bad debts									15		
	16	Rents									16		
	17	Taxes and licenses									17		
	18	Interest									18		
	19	Charitable contributions									19		
	20	Depreciation from Form 4562 not claimed on Schedule A or elsewhere on return (attach Form 4562)									20		
	21	Depletion									21		
	22	Advertising									22		
	23	Pension, profit-sharing, etc., plans									23		
	24	Employee benefit programs									24		
	25	Domestic production activities deduction (attach Form 8903)									25		
	26	Other deductions (attach schedule)									26		
	27	Total deductions. Add lines 12 through 26									▶	27	
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11.										28	
29	Less: a Net operating loss deduction (see instructions)									29a			
		b Special deductions (Schedule C, line 20)								29b			
29c										29c			
30	Taxable income. Subtract line 29c from line 28 (see instructions)										30		
31	Total tax (Schedule J, line 10)										31		
Tax, Refundable Credits, and Payments	32a	2009 overpayment credited to 2010		32a									
	b	2010 estimated tax payments		32b									
	c	2010 refund applied for on Form 4466		32c	()	d	Bal ▶	32d			
	e	Tax deposited with Form 7004								32e			
	f	Credits: (1) Form 2439 (2) Form 4136								32f			
	g	Refundable credits from Form 3800, line 19c, and Form 8827, line 8c								32g			
	32h										32h		
33	Estimated tax penalty (see instructions). Check if Form 2220 is attached									▶ <input type="checkbox"/>	33		
34	Amount owed. If line 32h is smaller than the total of lines 31 and 33, enter amount owed										34		
35	Overpayment. If line 32h is larger than the total of lines 31 and 33, enter amount overpaid										35		
36	Enter amount from line 35 you want: Credited to 2011 estimated tax ▶										▶	36	
												▶	Refunded ▶

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Sign Here	Signature of officer _____	Date _____	Title _____
	May the IRS discuss this return with the preparer shown below (see instructions)? <input type="checkbox"/> Yes <input type="checkbox"/> No		

Paid Preparer Use Only	Print/Type preparer's name _____	Preparer's signature _____	Date _____	Check <input type="checkbox"/> if self-employed	PTIN _____
	Firm's name ▶ _____	Firm's EIN ▶ _____			
	Firm's address ▶ _____	Phone no. _____			

Schedule A Cost of Goods Sold (see instructions)

1	Inventory at beginning of year	1	
2	Purchases	2	
3	Cost of labor	3	
4	Additional section 263A costs (attach schedule)	4	
5	Other costs (attach schedule)	5	
6	Total. Add lines 1 through 5	6	
7	Inventory at end of year	7	
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on page 1, line 2	8	

9a Check all methods used for valuing closing inventory:

(i) Cost

(ii) Lower of cost or market

(iii) Other (Specify method used and attach explanation.) ▶

b Check if there was a writedown of subnormal goods ▶

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO **9d**

e If property is produced or acquired for resale, do the rules of section 263A apply to the corporation? Yes No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation Yes No

Schedule C Dividends and Special Deductions (see instructions)

	(a) Dividends received	(b) %	(c) Special deductions (a) × (b)
1 Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)		70	
2 Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	
3 Dividends on debt-financed stock of domestic and foreign corporations		see instructions	
4 Dividends on certain preferred stock of less-than-20%-owned public utilities		42	
5 Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	
6 Dividends from less-than-20%-owned foreign corporations and certain FSCs		70	
7 Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	
8 Dividends from wholly owned foreign subsidiaries		100	
9 Total. Add lines 1 through 8. See instructions for limitation			
10 Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11 Dividends from affiliated group members		100	
12 Dividends from certain FSCs		100	
13 Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14 Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15 Foreign dividend gross-up			
16 IC-DISC and former DISC dividends not included on lines 1, 2, or 3			
17 Other dividends			
18 Deduction for dividends paid on certain preferred stock of public utilities			
19 Total dividends. Add lines 1 through 17. Enter here and on page 1, line 4 ▶			
20 Total special deductions. Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b ▶			

Schedule E Compensation of Officers (see instructions for page 1, line 12)

Note: Complete Schedule E only if total receipts (line 1a plus lines 4 through 10 on page 1) are \$500,000 or more.

(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of corporation stock owned		(f) Amount of compensation
			(d) Common	(e) Preferred	
1		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
		%	%	%	
2 Total compensation of officers					
3 Compensation of officers claimed on Schedule A and elsewhere on return					
4 Subtract line 3 from line 2. Enter the result here and on page 1, line 12					

Schedule J Tax Computation (see instructions)

1	Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120))	<input type="checkbox"/>	
2	Income tax. Check if a qualified personal service corporation (see instructions)	<input type="checkbox"/>	2
3	Alternative minimum tax (attach Form 4626)		3
4	Add lines 2 and 3		4
5a	Foreign tax credit (attach Form 1118)	5a	
b	Credit from Form 8834, line 29	5b	
c	General business credit (attach Form 3800)	5c	
d	Credit for prior year minimum tax (attach Form 8827)	5d	
e	Bond credits from Form 8912	5e	
6	Total credits. Add lines 5a through 5e		6
7	Subtract line 6 from line 4		7
8	Personal holding company tax (attach Schedule PH (Form 1120))		8
9	Other taxes. Check if from: <input type="checkbox"/> Form 4255 <input type="checkbox"/> Form 8611 <input type="checkbox"/> Form 8697 <input type="checkbox"/> Form 8866 <input type="checkbox"/> Form 8902 <input type="checkbox"/> Other (attach schedule)		9
10	Total tax. Add lines 7 through 9. Enter here and on page 1, line 31		10

Schedule K Other Information (see instructions)

1	Check accounting method: a <input type="checkbox"/> Cash b <input type="checkbox"/> Accrual c <input type="checkbox"/> Other (specify) ▶	Yes	No
2	See the instructions and enter the:		
a	Business activity code no. ▶		
b	Business activity ▶		
c	Product or service ▶		
3	Is the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? If "Yes," enter name and EIN of the parent corporation ▶		
4	At the end of the tax year:		
a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part I of Schedule G (Form 1120) (attach Schedule G)		
b	Did any individual or estate own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part II of Schedule G (Form 1120) (attach Schedule G)		
5	At the end of the tax year, did the corporation:		
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on Form 851, Affiliations Schedule? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv).		

(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage Owned in Voting Stock

Schedule K *Continued*

				Yes	No
b Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv).					
(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Country of Organization	(iv) Maximum Percentage Owned in Profit, Loss, or Capital		

6 During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.) Yes No
 If "Yes," file Form 5452, Corporate Report of Nondividend Distributions.
 If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.

7 At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of (a) the total voting power of all classes of the corporation's stock entitled to vote or (b) the total value of all classes of the corporation's stock? Yes No
 For rules of attribution, see section 318. If "Yes," enter:
 (i) Percentage owned ▶ _____ and (ii) Owner's country ▶ _____
 (c) The corporation may have to file Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached ▶ _____

8 Check this box if the corporation issued publicly offered debt instruments with original issue discount
 If checked, the corporation may have to file Form 8281, Information Return for Publicly Offered Original Issue Discount Instruments.

9 Enter the amount of tax-exempt interest received or accrued during the tax year ▶ \$ _____

10 Enter the number of shareholders at the end of the tax year (if 100 or fewer) ▶ _____

11 If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here
 If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.

12 Enter the available NOL carryover from prior tax years (do not reduce it by any deduction on line 29a.) ▶ \$ _____

13 Are the corporation's total receipts (line 1a plus lines 4 through 10 on page 1) for the tax year and its total assets at the end of the tax year less than \$250,000? Yes No
 If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2 on page 5. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year. ▶ \$ _____

14 Is the corporation required to file Schedule UTP (Form 1120), Uncertain Tax Position Statement (see instructions)? Yes No
 If "Yes," complete and attach Schedule UTP.

Schedule L Balance Sheets per Books		Beginning of tax year		End of tax year	
		(a)	(b)	(c)	(d)
Assets					
1	Cash				
2a	Trade notes and accounts receivable				
b	Less allowance for bad debts	()		()	
3	Inventories				
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)				
6	Other current assets (attach schedule)				
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach schedule)				
10a	Buildings and other depreciable assets				
b	Less accumulated depreciation	()		()	
11a	Depletable assets				
b	Less accumulated depletion	()		()	
12	Land (net of any amortization)				
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	()		()	
14	Other assets (attach schedule)				
15	Total assets				
Liabilities and Shareholders' Equity					
16	Accounts payable				
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (attach schedule)				
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more				
21	Other liabilities (attach schedule)				
22	Capital stock: a Preferred stock				
	b Common stock				
23	Additional paid-in capital				
24	Retained earnings—Appropriated (attach schedule)				
25	Retained earnings—Unappropriated				
26	Adjustments to shareholders' equity (attach schedule)				
27	Less cost of treasury stock	()		()	
28	Total liabilities and shareholders' equity				

Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return

Note: Schedule M-3 required instead of Schedule M-1 if total assets are \$10 million or more—see instructions

1	Net income (loss) per books		7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books			Tax-exempt interest \$	
3	Excess of capital losses over capital gains				
4	Income subject to tax not recorded on books this year (itemize):				
5	Expenses recorded on books this year not deducted on this return (itemize):		8	Deductions on this return not charged against book income this year (itemize):	
a	Depreciation \$		a	Depreciation \$	
b	Charitable contributions \$		b	Charitable contributions \$	
c	Travel and entertainment \$				
6	Add lines 1 through 5		9	Add lines 7 and 8	
			10	Income (page 1, line 28)—line 6 less line 9	

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)

1	Balance at beginning of year		5	Distributions: a Cash	
2	Net income (loss) per books			b Stock	
3	Other increases (itemize):			c Property	
			6	Other decreases (itemize):	
			7	Add lines 5 and 6	
4	Add lines 1, 2, and 3		8	Balance at end of year (line 4 less line 7)	

Note: *The following instructions are provided for informational purposes only. Because these forms are more specific in nature and do not apply in many situations, there are no review questions or final exam questions associated with this information.*

Material related to test questions begins again at Chapter 3.

Schedule M-3 (Form 1120) – Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More	Page 2-44
Form 4626 – Alternative Minimum Tax- Corporations	Page 2-97
Form 1120S – U.S. Income Tax Return for an S Corporation	Page 2-123
Schedule A. Cost of Goods Sold	Page 2-157
Schedule B. Other Information	Page 2-159
General Instructions for Schedule K and K-1. Shareholders’ Shares on Income, Credits, Deductions, etc.	Page 2-160
Specific Instructions (Schedule K-1 only)	Page 2-162
Specific Instructions (Schedules K and K-1, Part III)	Page 2-164
Schedule L. Balance Sheet per Books	Page 2-196
Schedule M-1. Reconciliation of Income (Loss) per Books With Income (Loss) per Return	Page 2-197
Schedule M-2. Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders’ Undistributed Taxable Income Previously Taxed	Page 2-197
Schedule K-1 (Form 1120S)	Page 2-206

Schedule M-3 (Form 1120) – Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More

I. General Instructions

PURPOSE OF SCHEDULE

Schedule M-3 Part I asks certain questions about the corporation's financial statements and reconciles financial statement worldwide net income (loss) for the corporation (or consolidated financial statement group, if applicable), as reported on Schedule M-3, Part I, line 4a, to net income (loss) per the income statement of the corporation for U.S. taxable income purposes, as reported on Schedule M-3, Part I, line 11.

Schedule M-3 Parts II and III reconcile financial statement net income (loss) for the U.S. corporation (or consolidated tax group, if applicable) as reported on Schedule M-3, Part I, line 11, to taxable income on Form 1120, page 1, line 28.

WHO MUST FILE

- Any domestic corporation or group of corporations required to file Form 1120, U.S. Corporation Income Tax Return, that reports on Schedule L of Form 1120 total assets at the end of the corporation's tax year that equal or exceed \$10 million must complete and file Schedule M-3 instead of Schedule M-1, Reconciliation of Income (Loss) per Books With Income per Return.
- A corporation filing a non-consolidated Form 1120, U.S. Corporation Income Tax Return, that reports on Schedule L for Form 1120 total assets that equal or exceed \$10 million must complete and file Schedule M-3 instead of Schedule M-1 and must check box (1) Non-consolidated return, at the top of Page 1 of Schedule M-3.
- Any U.S. consolidated tax group consisting of a U.S. parent corporation and additional includible corporations listed on Form 851, Affiliations Schedule, required to file Form 1120, that reports on Schedule L of Form 1120 total consolidated assets at the end of the tax year that equal or exceed \$10 million must complete and file Schedule M-3 instead of Schedule M-1, and must check box (2) consolidated return (Form 1120 only), or box (3) Mixed 1120/L/PC group, as applicable, at the top of Page 1 of Schedule M-3.

A U.S. corporation filing Form 1120 that is not required to file Schedule M-3 may voluntarily file Schedule M-3 instead of Schedule M-1. A corporation filing Schedule M-3 must check the box on Form 1120, page 1, item A, indicating that Schedule M-3 is attached, whether required or voluntary. A corporation filing Schedule M-3 must not file Schedule M-1.

Example 1.

1. U.S. corporation A owns U.S. subsidiary B and foreign subsidiary F. For its 2010 tax year, A prepares consolidated financial statements with B and F that report total assets of \$12 million. A files a consolidated U.S. federal income tax return with B and reports total consolidated assets on Schedule L of \$8 million. A's U.S. consolidated tax group is not required to file Schedule M-3 for the 2010 tax year.

2. U.S. corporation C owns U.S. subsidiary D. For its 2010 tax year, C prepares consolidated financial statements with D, but C and D file separate U.S. federal income tax returns. The consolidated accrual basis financial statements for C and D report total assets at the end of the tax year of \$12 million after intercompany eliminations. C reports separate company total year-end assets on its Schedule L of \$7 million. D reports separate company total year-end assets on its Schedule L of \$6 million. Neither C nor D is required to file Schedule M-3 for the 2010 tax year.

3. Foreign corporation A owns 100 percent of both U.S. corporation B and U.S. corporation C. C owns 100 percent of U.S. corporation D. For its 2010 tax year, A prepares a consolidated worldwide financial statement for the ABCD consolidated group. The ABCD consolidated financial statement reports total year-end assets of \$25 million. A is not required to file a U.S. federal income tax return. B files a separate U.S. federal income tax return and reports separate company total year-end assets on its Schedule L of \$12 million. C files a consolidated U.S. federal income tax return with D and, after eliminating intercompany transactions between C and D, reports consolidated total year-end assets on Schedule L of \$8 million. B is required to file Schedule M-3 because its total year-end assets reported on Schedule L exceed \$10 million. The CD U.S. consolidated tax group is not required to file Schedule M-3 because its total year-end assets reported on Schedule L do not exceed \$10 million.

OTHER ISSUES AFFECTING SCHEDULE M-3 FILING REQUIREMENTS

If a corporation was required to file Schedule M-3 for the preceding tax year but reports on Schedule L of Form 1120 total consolidated assets at the end of the current tax year of less than \$10 million, the corporation is not required to file Schedule M-3 for the current tax year. The corporation may either (a) file Schedule M-3, or (b) file Schedule M-1, for the current tax year. However, if the corporation chooses to file Schedule M-1 for the current tax year, and for a subsequent tax year the corporation is required to file Schedule M-3, the corporation must complete Schedule M-3 in its entirety (Part I and all columns in Parts II and III) for that subsequent tax year.

In the case of a U.S. consolidated tax group, total assets at the end of the tax year must be determined based on the total year-end assets of all includible corporations listed on Form 851, net of eliminations for intercompany transactions and balances between the includible corporations. In addition, for purposes of determining for Schedule M-3 whether the corporation (or U.S. consolidated tax group) has total assets at the end of the current tax year of \$10 million or more, the corporation's total consolidated assets must be determined on an overall accrual method of accounting unless both of the following apply: (a) the tax returns of all includible corporations in the U.S. consolidated

tax group are prepared using an overall cash method of accounting, and (b) no includible corporation in the U.S. consolidated tax group prepares or is included in financial statements prepared on an accrual basis.

OTHER FORM 1120 SCHEDULES AFFECTED BY SCHEDULE M-3 REQUIREMENTS

Report on Schedules L, M-2, and Form 1120, page 1, amounts for the U.S. corporation or, if applicable, the U.S. consolidated tax group.

Schedule L

If a non-tax-basis income statement and related non-tax-basis balance sheet is prepared for any purpose for a period ending with or within the tax year, Schedule L must be prepared showing non-tax-basis amounts. See the instructions for Part I, line 1, for the discussion of non-tax-basis income statements and related non-tax-basis balance sheets prepared for any purpose and the impact on the selection of the income statement used for Schedule M-3 and the related non-tax-basis balance sheet amounts that must be used for Schedule L.

Total assets shown on Schedule L, line 15, column (d) (or, in the case of some consolidated mixed groups with a Form 1120 parent and an insurance subsidiary, the assets reported on form 1120, page 1, item D), must equal the total assets of the corporation (or, in the case of a U.S. consolidated tax group, the total assets of all members of the group listed on Form 851) as of the last day of the tax year, and must be the same total assets reported by the corporation (or by each member of the U.S. consolidated tax group) in the financial statements, if any, used for Schedule M-3. If the corporation prepares financial statements, Schedule L must equal the sum of the financial statement total assets for each corporation listed on Form 851 and included in the consolidated U.S. federal income tax return (includible corporation) net of eliminations for intercompany transactions between includible corporations. If the corporation does not prepare financial statements, Schedule L must be based on the corporation's books and records. The Schedule L balance sheet may show tax-basis balance sheet amounts if the corporation is allowed to use books and records for Schedule M-3 and the corporation's books and records reflect only tax-basis amounts.

Generally, total assets at the beginning of the year (Schedule L, line 15, column (b)) must equal total assets at the close of the prior year (Schedule L, line 15, column (d)). For each Schedule L balance sheet item reported for which there is a difference between the current opening balance sheet amount and the prior closing balance sheet amount attach a schedule that reports the balance sheet item, the prior closing amount, the current opening amount, and a short explanation of the change. Such reasons for these differences include mergers and acquisitions.

For purposes of measuring total assets at the end of the year, assets may not be netted or offset against liabilities. In addition, total assets may not be reported as a negative amount. If Schedule L is prepared on a non-tax-basis method, an investment in a partnership may be shown as appropriate under the corporation's non-tax-basis method of accounting, including, if required by the corporation's reporting methodology, the equity method of accounting for investments. If Schedule L is prepared on a tax-basis, an investment by the corporation in a partnership must be shown as an asset and

measured by the corporation's adjusted basis in its partnership interest. Any liabilities contributing to such adjusted basis must be shown on Schedule L as corporate liabilities.

Schedule M-2

The amount shown on Schedule M-2, line 2, Net income (loss) per books, must equal the amount shown on Schedule M-3, Part I, line 11. Schedule M-2 must reflect activity only of corporations included in the consolidated U.S. income tax return.

Consolidated Return (Form 1120, Page 1)

Report on Form 1120, page 1, each item of income, gain, loss, expense, or deduction net of elimination entries for intercompany transactions between includible corporations. The corporation must not report as dividends on Form 1120, Schedule C, any amounts received from an includible corporation. In general, dividends received from an includible corporation must be eliminated in consolidation rather than offset by the dividends-received deduction.

ENTITY CONSIDERATIONS FOR SCHEDULE M-3

For purposes of Schedule M-3, references to the classification of an entity (for example, as a corporation, a partnership, or a trust) are references to the treatment of the entity for U.S. federal income tax purposes. An entity that generally is disregarded as separate from its owner for U.S. federal income tax purposes (disregarded entity) must not be separately reported on Schedule M-3 except, if required, on Part I, line 7a or 7b. On Schedule M-3, Parts II and III, any item of income, gain, loss, deduction, or credit of a disregarded entity must be reported as an item of its owner. In particular, the income or loss of a disregarded entity must not be reported on Part II, lines 9, 10, or 11 as from a separate partnership or other pass-through. The financial statement income or loss of a disregarded entity is included on Part I, line 7a or 7b, only if its financial statement income or loss is included on Part I, line 11, but not on Part I, line 4a.

CONSOLIDATED SCHEDULE M-3 VERSUS CONSOLIDATING SCHEDULES M-3 FOR FORM 1120 GROUPS

A consolidated tax return group with a parent corporation that files a Form 1120 is a mixed group if any member is a life insurance company (files using Form 1120-L) or a property and casualty insurance company (files using 1120-PC).

A U.S. consolidated tax group must file a consolidated Schedule M-3. Parts I, II, and III of the consolidated Schedule M-3 must reflect the activity of the entire U.S. consolidated tax group. The parent corporation also must complete Parts II and III of a separate Schedule M-3 to reflect the parent's own activity. In addition, Parts II and III of a separate Schedule M-3 must be completed by each includible corporation to reflect the activity of that includible corporation. Lastly, it generally will be necessary to complete Parts II and III of a separate Schedule M-3 for consolidation eliminations.

If a U.S. consolidated tax group that is not a mixed group consists of four includible corporations (the parent and three subsidiaries), the U.S. consolidated tax group must complete six Schedules M-3 as follows: (a) one consolidated Schedule M-3 with Parts I, II, and III completed to reflect the activity of the entire U.S. consolidated tax group; (b) Parts II and III of a separate Schedule M-3 for each of the four includible corporations to

reflect the activity of each includible corporation; and (c) Parts II and III of a separate Schedule M-3 to eliminate intercompany transactions between includible corporations and to include limitations on deductions (e.g., charitable contribution limitations and capital loss limitations) and carryover amounts (e.g., charitable contribution carryovers and capital loss carryovers).

Note. Complete only one Schedule M-3, Part I, for each consolidated group. A subsidiary of a consolidated group does not complete Schedule M-3, Part I. Enter on Schedule M-3, Part I, the name and EIN of the common parent of the consolidated group. Indicate on Schedule M-3, Parts II and III, on the line after the common parent's name and EIN, whether the Schedule M-3, Parts II and III, is for the: (1) consolidated group; (2) parent corporation; (3) consolidation eliminations; or (4) subsidiary corporation, by checking the appropriate box. If Schedule M-3, Parts II and III, are for a subsidiary in a consolidated return, also enter the name and EIN of the subsidiary.

COMPLETION OF SCHEDULE M-3 AND CERTAIN ALLOCATIONS, LIMITATIONS, AND CARRYOVERS

A corporation (or any member of a U.S. consolidated tax group) required to file Schedule M-3 must complete the form in its entirety. In particular, a corporation filing a nonconsolidated return that meets the filing requirements for Schedule M-3 must complete Parts I, II, and III. Such a corporation does not check any of the checkboxes at the top of Parts II and III. In the case of a U.S. consolidated tax group, Part I must be completed once, on the consolidated Schedule M-3, by the parent corporation. Parts II and III must be completed by the parent corporation, each includible corporation, and a consolidating eliminations entity.

At the time the Form 1120 is filed, all applicable questions must be answered on Part I (except that in the case of a U.S. consolidated tax group, Part I must be completed once, on the consolidated Schedule M-3, by the parent corporation), all columns must be completed on Parts II and III, and all numerical data required by Schedule M-3 must be provided at the time the Form 1120 is filed. Any schedule required to support a line item on Schedule M-3 must be attached at the time Schedule M-3 is filed and must provide the information required for that line item.

All detailed schedules for Part II and Part III of Schedule M-3 must be attached for each separate entity included in the consolidated Part II and Part III, including those for the parent company and the eliminations entity, if applicable. It is not required that the same supporting detailed information be presented on the separate consolidated supporting schedules for Part II and Part III of the consolidated Schedule M-3.

If an item attributable to an includible corporation is not shared by or allocated to the appropriate member of the group but is retained in the parent corporation's financial statements (or books and records, if applicable), then the item must be reported by the parent corporation on its separate Schedule M-3. For example, if the parent of a U.S. consolidated tax group prepares financial statements that include all members of the U.S. consolidated tax group and the parent does not allocate the group's income tax expense as reflected in the financial statements among the members of the group but retains it in the parent corporation, the parent corporation must report on its separate Schedule M-3 the U.S. consolidated tax group's income tax expense as reflected in the financial statements.

Any adjustments made at the consolidated group level that are not attributable to any specific member of the U.S. consolidated tax group (e.g., disallowance of net capital losses, contribution deduction carryovers, and limitation of contribution deductions) must not be reported on the separate consolidating parent or subsidiary Schedules M-3 but rather on the consolidated Schedule M-3 and on the consolidating Schedule M-3 for consolidation eliminations (or on Form 8916 in the case of a mixed group).

If an includible corporation has (1) no activity for the tax year (e.g., because the corporation is a dormant or inactive corporation), (2) no amount for the corporation was included in Part I, line 11, and (3) the corporation has no amounts to report on Part II and Part III of Schedule M-3 for the tax year, the parent corporation of the U.S. consolidated tax group may attach to the consolidated Schedule M-3 a statement that provides the name and EIN of the includible corporation in lieu of filing a blank Part II and Part III of Schedule M-3 for such entity. On Part I, check box (4) Dormant subsidiaries schedule attached.

II. Specific Instructions for Part I

PART I. FINANCIAL INFORMATION AND NET INCOME (LOSS) RECONCILIATION

When To Complete Part I

Part I must be completed for any tax year for which the corporation files Schedule M-3.

Line 1. Questions Regarding the Type of Income Statement Prepared

For Part I, lines 1 through 12, use only the financial statements of the U.S. corporation filing the U.S. federal income tax return (the consolidated financial statements for the U.S. parent corporation of a U.S. consolidated tax group). If the U.S. corporation filing a U.S. federal income tax return (or the U.S. parent corporation of a U.S. consolidated tax group) prepares its own financial statements but is controlled by another corporation (U.S. or foreign) that prepares financial statements that include the U.S. corporation, the U.S. corporation (or the U.S. parent corporation of a U.S. consolidated tax group) must use for its Schedule M-3, Part I, its own financial statements and not the financial statements of the controlling corporation .

If a non-publicly traded U.S. parent corporation of a U.S. consolidated tax group prepares financial statements and that group includes a publicly traded subsidiary that files financial statements with the Securities and Exchange Commission (SEC), the consolidated financial statements of the parent corporation are the appropriate financial statements for purposes of completing Part I. Do not use any separate company financial statements that might be prepared for publicly traded subsidiaries.

If no non-tax-basis financial statements are prepared for a U.S. corporation (or, in the case of a U.S. consolidated tax group, for the U.S. parent corporation's consolidated group) filing Schedule M-3 (Form 1120), the U.S. corporation (or the U.S. parent corporation of a U.S. consolidated tax group) must enter "No" on questions 1a, 1b, and 1c, skip Part I, lines 2a through 3c, and enter the net income (loss) per the books and records of the U.S. corporation (or U.S. consolidated tax group) on Part I, line 4a.

If no non-tax-basis financial statements are prepared for a U.S. corporation (or, in the case of a U.S. consolidated tax group, for the U.S. parent corporation's consolidated group) filing Form 1120 Schedule M-3, and the U.S. corporation is owned by a foreign corporation that prepares financial statements that includes the U.S. corporation (or the U.S. parent corporation's consolidated group), the U.S. corporation (or the U.S. parent corporation of the U.S. consolidated tax group) must enter "No" on questions 1a, 1b, and 1c, skip Part I, lines 2a through 3c, and enter the net income (loss) per the books and records of the U.S. corporation (or U.S. consolidated tax group) on Part I, line 4a.

Line 2. Questions Regarding Income Statement Period and Restatements

Enter the beginning and ending dates on line 2a for the corporation's annual income statement period ending with or within the current tax year.

The questions on Part I, lines 2b and 2c, regarding income statement restatements refer to the worldwide consolidated income statement issued by the corporation filing the U.S. federal income tax return (the consolidated financial statements for the U.S. parent corporation of a U.S. consolidated tax group). Answer "Yes" on lines 2b and/or 2c if the corporation's annual income statement has been restated for any reason. Attach a short explanation of the reasons for the restatement in net income for each annual income statement period that is restated, including the original amount and restated amount of each annual statement period's net income. The attached schedule is not required to report restatements on an entity-by-entity basis.

Line 3. Questions Regarding Publicly Traded Voting Common Stock

The primary U.S. publicly traded voting common stock class is the most widely held or most heavily traded within the U.S. as determined by the corporation. If the corporation has more than one class of publicly traded voting common stock, attach a list of the classes of publicly traded voting common stock, the trading symbol of each class, and the nine-digit CUSIP number of each class.

Line 4a. Worldwide Consolidated Net Income (Loss) per Income Statement

Report on Part I, line 4a, the worldwide consolidated net income (loss) per the income statement (or books and records, if applicable) of the corporation. A corporation filing a non-consolidated Form 1120 for itself must report its worldwide income on Part I, line 4a.

In completing Schedule M-3, the corporation must use financial statement amounts from the financial statement type checked "Yes" on Part I, line 1, or from its books and records if Part I, line 1c is checked "No." If Part I, line 1a, is checked "Yes," report on Part I, line 4a, the net income amount reported in the income statement presented to the SEC on the corporation's Form 10-K (the Form 10-K for the security identified on Part I, line 3b, if applicable).

If a corporation prepares non-tax-basis financial statements, the amount on line 4a must equal the financial statement net income (loss) for the income statement period ending with or within the tax year as indicated on Part I, line 2a.

If the corporation prepares non-tax-basis financial statements and the income statement period differs from the corporation's tax year, the income statement period indicated on Part I, line 2a, applies for purposes of Part I, lines 4a through 8.

If the corporation does not prepare non-tax-basis financial statements, check "No" on Part I, line 1c, and enter the net income (loss) per the books and records of the U.S. corporation or the U.S. consolidated tax group on Part I, line 4a.

Indicate on Part I, line 4b, which of the following accounting standards were used for line 4a.

1. U.S. Generally Accepted Accounting Principles (GAAP).
2. International Financial Reporting Standards (IFRS)
3. Statutory.
4. Tax Basis.
5. Other (Specify).

Report on Part I, lines 5a through 10, as instructed below, all adjustment amounts required to adjust worldwide net income (loss) reported on this Part I, line 4a (whether from financial statements or books and records), to net income (loss) of includible corporations that must be reported on Part I, line 11.

Report on line 12a the worldwide consolidated total assets and total liabilities amounts for the corporation using the same financial statements (or books and records) used for the worldwide consolidated income (loss) amount reported on Part I, line 4a.

If a U.S. corporation (a) has net income (loss) included on Part I, line 4a, and removed on Part I, line 6a or 6b, on another U.S. corporation's Schedule M-3, (b) files its own Form 1120 (separate or consolidated), (c) does not have a separate financial statement (certified or otherwise) of its own, and (d) reports on Schedule L of its own Form 1120 total consolidated assets that equal or exceed \$10,000,000 at the end of the corporation's tax year, the corporation must answer questions 1a, 1b, and 1c of Part I as appropriate for its own Form 1120 and must report on Part I, line 4a, the amount for the corporation's net income (loss) that is removed on Part I, line 6a or 6b of the other corporation's Schedule M-3. However, if in the circumstances described immediately above, the corporation does have separate financial statements (certified or otherwise) of its own, independent of the amount of the corporation's net income included on Part I, line 4a, of the other U.S. corporation, the corporation must answer questions 1a, 1b, and 1c of Part I, as appropriate, for its own Form 1120, based on its own separate income statement, and must report on Part I, line 4a, the net income amounts shown on its separate income statement.

If line 4a includes net income (loss) for a corporation that files Form 1120-PC or Form 1120-L, see the instructions for Part I, line 10, for adjustments that may be necessary to reconcile financial statement income to statutory income.

Line 5. Net Income (Loss) of Nonincludible Foreign Entities

Remove the financial statement net income (line 5a) or loss (line 5b) of each foreign entity that is included on line 4a and is not an includible corporation in the U.S. consolidated tax group (nonincludible foreign entity). In addition, on Part I, line 8, adjust for consolidation eliminations and correct for minority interest and intercompany

dividends between any nonincludible foreign entity and any includible corporation. Do not remove in Part I the financial statement net income (loss) of any nonincludible foreign entity accounted for on line 4a using the equity method.

Attach a supporting schedule that provides the name, EIN (if applicable), and net income (loss) per the financial statement or books and records included on line 4a that is removed on this line 5 for each separate nonincludible foreign entity. Also, state the total assets and total liabilities for each such separate nonincludible U.S. entity and include those assets and liabilities amounts in the total assets and total liabilities reported on Part I, line 12b. The amounts of income (loss) detailed on the supporting schedule should be reported for each separate nonincludible foreign entity without regard to the effect of consolidation or elimination entries. If there are consolidation or elimination entries relating to nonincludible foreign entities whose income (loss) is reported on the attached schedule that are not reportable on Part I, line 8, the net amounts of all such consolidation and elimination entries must be reported on a separate line on the attached schedule, so that the separate financial accounting income (loss) of each nonincludible foreign entity remains separately stated.

For example, if the net income (after consolidation and elimination entries) of a nonincludible foreign sub-consolidated group is being reported on line 5a, the attached supporting schedule should report the income (loss) of each separate nonincludible foreign legal entity from each such entity's own financial accounting net income statement or books and records, and any consolidation or elimination entries (for intercompany dividends, minority interests, etc.) not reportable on Part I, line 8, should be reported on the attached supporting schedule as a net amount on a line separate and apart from lines that report each nonincludible foreign entity's separate net income (loss).

Line 6. Net Income (Loss) of Nonincludible U.S. Entities

Remove the financial statement net income (line 6a) or loss (line 6b) of each U.S. entity that is included on line 4a and is not an includible corporation in the U.S. consolidated tax group (nonincludible U.S. entity). In addition, on Part I, line 8, adjust for consolidation eliminations and correct for minority interest and intercompany dividends between any nonincludible U.S. entity and any includible corporation. Do not remove in Part I the financial statement net income (loss) of any nonincludible U.S. entity accounted for on line 4a using the equity method.

Attach a supporting schedule that provides the name, EIN, and net income (loss) per the financial statement or books and records included on line 4a that is removed on this line 6 for each separate nonincludible U.S. entity. Also, state the total assets and total liabilities for each such separate nonincludible U.S. entity and include those assets and liabilities amounts in the total assets and total liabilities reported on Part I, line 12c. The amounts of income (loss) detailed on the supporting schedule should be reported for each separate nonincludible U.S. entity without regard to the effect of consolidation or elimination entries. If there are consolidation or elimination entries relating to nonincludible U.S. entities whose income (loss) is reported on the attached schedule that are not reportable on Part I, line 8, the net amounts of all such consolidation and elimination entries must be reported on a separate line on the attached schedule, so that the separate financial accounting income (loss) of each nonincludible U.S. entity remains separately stated. For example, if the net income (after consolidation and elimination

entries) of a nonincludible U.S. sub-consolidated group is being reported on line 6a, the attached supporting schedule should report the income (loss) of each separate nonincludible U.S. legal entity from each such entity's own financial accounting net income statement or books and records, and any consolidation or elimination entries (for intercompany dividends, minority interests, etc.) not reportable on Part I, line 8, should be reported on the attached supporting schedule as a net amount on a line separate and apart from lines that report each nonincludible U.S. entity's separate net income (loss).

Line 7. Net Income (Loss) of Other Includible Foreign Disregarded Entities, Other Includible U.S. Disregarded Entities, and Other Includible Entities

Include on line 7a, 7b, or 7c the financial net income or (loss) of each foreign or U.S. disregarded entity or other includible entry that is not included in the consolidated financial group and therefore not included in the income reported on Part I, line 4a. Include on line 7a or 7b financial income of any disregarded entity that is not included in the income reported on Part I, line 4a, but is included in Part I, line 11 (other disregarded entities). Include on line 7c the financial income of any entity not a disregarded entity that is not included in the income reported on line 4a, but is included on line 11 (other includible entities). In addition, on Part I, line 8, adjust for consolidation eliminations and correct for minority interest and intercompany dividends for any other disregarded entity or other includible entities.

Attach a supporting schedule that provides the name, EIN, and net income (loss) per the financial statement or books and records on lines 7a, 7b, and 7c for each separate other U.S. disregarded entity or other includible entity. Also, state the total assets and total liabilities for each such separate included entity and include those assets and liabilities amounts in the total assets and total liabilities reported on Part I, line 12d. The amounts of income (loss) detailed on the supporting schedule should be reported for each separate other disregarded entity or other includible entity without regard to the effect of consolidation or elimination entries solely between or among the entities listed. If there are consolidated or elimination entries relating to such disregarded entity or other includible entities whose income (loss) is reported on the attached schedule that are not reportable on Part I, line 8, the net amounts of all such consolidation and elimination entries must be reported on a separate line on the attached schedule, so that the separate financial accounting income (loss) of each other disregarded entity or other includible entity remains separately stated. For example, if the net income (after consolidation and elimination entries) of a sub-consolidated group of other U.S. disregarded entities is being reported on line 7b, the attached supporting schedule should report the income (loss) of each separate other U.S. disregarded entity from each entity's own financial accounting net income statement or books and records, and any consolidation or elimination entries (for intercompany dividends, minority interests, etc.) not reportable on Part I, line 8, should be reported on the attached supporting schedule as a net amount on a line separate and apart from lines that report each other includible corporation's or entity's separate net income (loss).

Line 8. Adjustment to Eliminations of Transactions Between Includible Entities and Nonincludible Entities

Adjustments on Part I, line 8, to reverse certain financial accounting consolidation or elimination entries are necessary to ensure that transactions between includible entities and nonincludible U.S. or foreign entities are not eliminated, in order to report the correct

total amount on Part I, line 11. Also, additional consolidation entries and eliminations entries may be necessary on Part I, line 8, related to transactions between includible entities that are in the consolidated financial group and other disregarded entities and other includible entities that are not in the consolidated financial group but that are reported on Part I, line 7a, 7b, or 7c in order to report the correct total amount on Part I, line 11.

Include on Part I, line 8, the total of the following: (a) amounts of any adjustments to consolidation entries and elimination entries that are contained in the amount reported on Part I, line 4a, required as a result of removing amounts on Part I, line 5 or 6; and (b) amounts of any additional consolidation entries and elimination entries that are required as a result of including amounts on Part I, line 7a, 7b, or 7c. This is necessary in order that the consolidation entries and intercompany eliminations entries included in the amount reported on Part I, line 11 are only those applicable to the financial net income (loss) of includible corporations for the financial statement period. For example, adjustments must be reported on line 8 to remove minority interest and to reverse the elimination of intercompany dividends included on Part I, line 4a, that relate to the net income of entities removed on Part I, line 5 or 6, because the income to which the consolidation or elimination entries relate has been removed. Also, for example, consolidation or elimination entries must be reported on line 8 to reflect any minority interest ownership in the net income of other disregarded entities or other includible entities reported on Part I, line 7a, 7b, or 7c, and to eliminate any intercompany dividends between entities whose income is included on Part I, line 7a, 7b, or 7c, and other entities included in the consolidated U.S. income tax return.

If a corporate owner of an interest in another entity (entity): (a) accounts for the interest in entity in the owner corporation's separate general ledger on the equity method, and (b) fully consolidates entity in the owner corporation's consolidated financial statements, but entity is not includible in the owner corporation's consolidated U.S. income tax return, then, as part of reversing all consolidation and elimination entries for the nonincludible entity, the corporate owner must reverse on Schedule M-3 Part I, line 8, the elimination of the equity income inclusion from entity. If the owner corporation does not account for entity on the equity method on its own general ledger, it will not have eliminated the equity income for consolidated financial statement purposes, and therefore will have no elimination of equity income to reverse.

The attached supporting schedule for Part I, line 8, must identify the type (e.g., minority interest, intercompany dividends, etc.) and amount of consolidation or elimination entries reported, as well as the names of the entities to which they pertain. It is not necessary, but it is permitted, to report intercompany eliminations that net to zero on Part I, line 8, such as intercompany interest income and expense.

Line 9. Adjustment to Reconcile Income Statement Period to Tax Year

Include on line 9 any adjustments necessary to the income (loss) of includible corporations to reconcile differences between the corporation's income statement period reported on line 2a and the corporation's tax year. Attach a schedule describing the adjustment.

Statutory accounting for an insurance company subsidiary acquired or merged may require the use of a financial statement period for income reported on Part I, line 11, that differs from the period reported on part I, line 4a or line 7. Report on Part I, line 10b, adjustments to income because of such differences in accounting period.

Line 10a. Intercompany Dividend Adjustments to Reconcile to Line 11

Line 10b. Other Statutory Accounting Adjustments to Reconcile to Line 11

Line 10c. Other Adjustments to Reconcile to Amount on Line 11

Include on lines 10a, 10b, and 10c any other adjustments to reconcile net income (loss) on Part I, line 4a through Part I, line 9, with net income (loss) on Part I, line 11. Include on line 10a the amount of any intercompany dividend adjustment required by statutory accounting. Include on line 10b the amount of any other required statutory accounting adjustment. Include on line 10c the amount of any other adjustment not required by statutory accounting.

Normally, all intercompany dividends will have been eliminated or excluded from the financial accounting consolidated net income (loss) reported on Part I, line 4a. However, an insurance company may be required to include certain intercompany dividends on Part I, line 11, so that the amount reported on Part I, line 11, agrees with statutory accounting net income (Annual Statement). If the net income (loss) of a corporation that files Form 1120-PC or Form 1120-L is included on Part I, line 4a or line 7, and is computed on a basis other than statutory accounting, include on line 10a the adjustments necessary such that Part I, line 11, includes intercompany dividends in the net income (loss) for such corporation to the extent required by statutory accounting principles. (For insurance companies included in the consolidated U.S. federal income tax return, see instructions for Part I, line 11 and Part II, line 7.)

Statutory accounting for an insurance company subsidiary acquired or merged may require the use of a financial statement period for income reported on Part I, line 11, that differs from the period reported on Part I, line 4a or line 7. Report on Part I, line 10b, adjustments to income because of such differences in accounting period.

For any adjustments reported on Part I, lines 10a, 10b, and 10c, attach a supporting schedule that provides, for each corporation to which an adjustment relates: the name and EIN of the corporation, the amount of net income included in Part I before any adjustments on line 10, the amount of net income included on Part I, line 11, the amount of the net adjustment that is attributable to intercompany dividend adjustments required to be reported by statutory accounting and included on Part I, line 10a, the amount of the net adjustment attributable to other statutory accounting requirements and included on Part I, line 10b, and the amount of the remainder of the net adjustment not required because of statutory accounting and included on Part I, line 10c. If any net adjustment is included for the corporation on Part I, lines 10b or 10c, attach a supplemental supporting schedule identifying the line (10b or 10c), the type of each adjustment included in the net adjustment, and the amount of each adjustment included in the net adjustment.

Line 11. Net Income (Loss) per Income Statement of Includible Corporations

Report on line 11 the net income (loss) per the consolidated income statement (or books and records, if applicable) net income (loss) of the corporation. In the case of a U.S. consolidated tax group, report the consolidated income statement net income (loss) of all corporations listed on Form 851 and included in the U.S. consolidated U.S. federal

income tax return for the tax year. Amounts reported in column (a) of Parts II and III (see instructions below) must be reported using the same accounting method as is used to report the amount of net income (loss) per income statement of includible corporations on Part I, line 11, which for insurance companies is statutory accounting. If an insurance company is included in a consolidated Form 1120, the amount of net income reported on Part I, Line 11, will include the statutory accounting net income for the insurance corporation and the GAAP net income for the non-insurance corporations included in the U.S. consolidated tax group. (For insurance companies included in the consolidated U.S. income tax return, see instructions for Part I, line 10 and Part II, line 7.)

Do not, in any event, report on this line 11 the net income of entities not listed on Form 851 and not included in the consolidated U.S. income tax return for the tax year. For example, it is not permissible to remove the income of non-includible entities on lines 5 and/or 6, above, then to add back such income on lines 7 through 10, such that the amount reported at line 11 includes the net income of entities not includible in the consolidated U.S. income tax return. A principal purpose of Schedule M-3 is to report on this Part I, line 11, only the financial accounting net income of only the corporations included in the consolidated U.S. income tax return.

Whether or not the corporation prepares financial statements, Part I, line 11, must include all items that impact the net income (loss) of the corporation even if they are not recorded in the profit and loss accounts in the corporation's general ledger, including, for example, all post-closing adjusting entries (including workpaper adjustments) and dividend income or other income received from non-includible corporations.

Example 2.

1. U.S. corporation P is publicly traded and files Form 10-K with the SEC. P owns 80% or more of the stock of 75 U.S. corporations DS1 through DS75, between 51% and 79% of the stock of 25 U.S. corporations DS76 through DS100, and 100% of the stock of 50 foreign subsidiaries FS1 through FS50. P eliminates all dividend income from DS1 through DS100 and FS1 through FS50 in financial statement consolidation entries. Furthermore, P eliminates the minority interest ownership, if any, of DS1 through DS100 in financial statement consolidation entries. P's SEC Form 10-K includes P, DS1 through DS100 and FS1 through FS50 on a fully consolidated basis. P files a consolidated U.S. income tax return with DS1 through DS75.

P must check "Yes" on Part I, line 1a. On Part I, line 4a, P must report the consolidated net income from the SEC Form 10-K for the consolidated financial statement group of P, DS1 through DS100, and FS1 through FS50. P must remove the net income (loss) of FS1 through FS50 on Part I, lines 5a or 5b, as applicable. P must remove the net income (loss) before minority interests of DS76 through DS100 on Part I, lines 6a or 6b, as applicable. P must reverse on Part I, line 8:

a. The elimination of dividends received by P and DS1 through DS75 from DS76 through DS100 and FS1 through FS50, and

b. The recognition of minority interest's share of the net income (loss) of DS1 through DS100. (Note: The minority interests' share, if any, of the income of DS1 through DS75 must be reported in Part II, line 8, Minority interest for includible corporations.)

P reports on Part I, line 11, the consolidated financial statement net income (loss) attributable to the includible corporations. Intercompany transactions between the includible corporations that had been eliminated in the net income amount on line 4a remain eliminated in the net income amount on line 11. Transactions between the includible corporations and the nonincludible entities that are eliminated in the net income amount on line 4a are included in the net income amount on line 11 since the elimination of those transactions were reversed on line 8.

2. Foreign corporation F owns 100% of the stock of U.S. corporation P. P owns 100% of the stock of DS1, 60% of the stock of DS2, and 100% of the stock of FS1. F prepares certified audited financial statements. P does not prepare any financial statements. P files a consolidated U.S. tax return with DS1.

P must not complete Schedule M-3, Part I, with reference to the financial statements of its foreign parent F. P must check "No" on Part I, lines 1a, 1b, and 1c, skip lines 2a through 3c of Part I, and enter worldwide net income (loss) per the books and records of the includible corporations (P and DS1) on Part I, line 4a. P must enter any necessary adjustments on lines 5a through 10 in order for Part I, line 11, to report the net income (loss) of includible corporations P and DS1, net of eliminations for transactions between P and DS1.

Example 3.

1. U.S. corporation P owns 60% of corporation DS1 which is fully consolidated in P's financial statements. P does not account for DS1 in P's separate general ledger on the equity method. DS1 has net income of \$100 (before minority interests) and pays dividends of \$50, of which P receives \$30. The dividend is eliminated in the consolidated financial statements. In its financial statements, P consolidates DS1 and includes \$60 of net income (\$100 less the minority interest of \$40) on Part I, line 4a.

P must remove the \$100 net income of DS1 on Part I, line 6a. P must reverse on Part I, line 8, the elimination of the \$40 minority interest net income of DS1. In addition, P reverses its elimination of the \$30 intercompany dividend in its financial statements on Part I, line 8. The net result is that P includes the \$30 dividend from DS1 at Part I, line 11, and on Part II, line 7, column (a). P's taxable dividend income from DS1 must be reported on Part II, line 7, column (d).

2. U.S. corporation C owns 60% of the capital and profits interests in U.S. LLC N. C does not account for N in C's separate general ledger on the equity method. N has net income of \$100 (before minority interests) and makes no distributions during the year. C treats N as a corporation for financial statement purposes and as a partnership for U.S. federal income tax purposes. In its financial statements, C consolidates N and includes \$60 of net income (\$100 less the minority interest of \$40) on Part I, line 4a.

C must remove the \$100 net income of N on Part I, line 6a. C must reverse on Part I, line 8, the elimination of the \$40 minority interest net income of N. The result is that C includes no income for N either on Part I, line 11 or on Part II, line 9, column (a). C's taxable income from N must be reported by C on Part II, line 9.

3. U.S. corporation P owns 60% of corporation DS1, which is fully consolidated in P's financial statements. P accounts for DS1 in P's separate general ledger on the equity method. DS1 has net income of \$100 (before minority interests) and pays dividends of \$50, of which P receives \$30. The dividend reduces P's investment in DS1 for equity method reporting on P's separate general ledger where P includes its 60% equity share of DS1 income, which is \$60. In its financial statements, P eliminates the DS1 equity method income of \$60 and consolidates DS1, including \$60 of net income (\$100 less the minority interest of \$40) on Part I, line 4a.

P must remove the \$100 net income of DS1 on Part I, line 6a. P must reverse on Part I, line 8, the elimination of the \$40 minority interest net income of DS1 and the elimination of the \$60 of DS1 equity income. The net result is that P includes the \$60 of equity method income from DS1 at Part I, line 11, and on Part II, line 6, column (a). P's taxable dividend income from its investment in DS1 must be reported on Part II, line 7, column (d).

4. U.S. corporation C owns 60% of the capital and profits interests in U.S. LLC N. C accounts for N in C's separate general ledger on the equity method. N has net income of \$100 (before minority interests) and makes no distributions during the tax year. C treats N as a corporation for financial statement purposes and as a partnership for U.S. income tax purposes. For equity method reporting on C's separate general ledger, C includes its 60% equity share of N income, which is \$60. In its financial statements, C eliminates the \$60 of N equity method income and consolidates N including \$60 of net income (\$100 less the minority interest of \$40) on Part I, line 4a.

C must remove the \$100 net income of N on Part I, line 6a. C must reverse on Part I, line 8, the elimination of the \$40 minority interest net income of N and the elimination of the \$60 of N equity method income. The result is that C includes the \$60 of equity method income for N on Part I, line 11, and on Part II, line 9, column (a). C's taxable income from N must be reported by C on Part II, line 9, column (d).

5. U.S. corporation C owns 60% of the capital and profits interests in U.S. LLC N. C accounts for N in C's separate general ledger on the equity method. N has net income of \$100 (before minority interests) and pays a \$50 cash distribution, of which C receives \$30. The dividend reduces C's investment in N for equity method reporting on C's separate general ledger. C treats N as a corporation for financial statement purposes and as a partnership for U.S. federal income tax purposes. For equity method reporting on C's separate general ledger, C includes its 60% equity share of N income, which is \$60. In its financial statements, C eliminates the \$60 of N equity method income and consolidates N and includes \$60 of net income (\$100 less the minority interest of \$40) on Part I, line 4a.

C must remove the \$100 net income of N on Part I, line 6a. C must reverse on Part I, line 8, the elimination of the \$40 minority interest net income of N and the elimination of the \$60 of N equity method income. The result is that C includes the \$60 of equity method income for N on Part I, line 11, and on Part II, line 9, column (a). C's taxable income from N must be reported by C on Part II, line 9, column (d).

Example 4.

U.S. corporation P owns 80% of the stock of corporation DS1. DS1 is included in P's consolidated federal income tax return, even though DS1 is not included in P's consolidated financial statements on either a consolidated basis or on the equity method. DS1 has current year net income of \$100 after taking into account its \$40 interest payment to P. P has net income of \$1,040 after recognition of the interest income from DS1. Because DS1 is an includible corporation, 100% of the net income of both P and DS1 must be reported on Form 1120, page 1 of the PDS consolidated U.S. income tax return, and the intercompany interest income and expense must be removed by consolidation elimination entries.

P must report its financial statement net income of \$1,040 on Part I, line 4a, and reports D's net income of \$100 on Part I, line 7c. Then, in order to reflect the full consolidation of the financial accounting net income of P and DS1 at Part I, line 11, the following consolidation and elimination entries are reported on Part I, line 8: (a) offsetting entries to remove the \$40 of interest income received from DS1 included by P on line 4a, and to remove the \$40 of interest expense of DS1 included in line 7c for a net change of zero; and (b) an entry to reflect the \$20 minority interest in the net income of DS1 (DS1 net income of \$100 × 20% minority interest). The result is that Part 1, line 11, reports \$1,120: \$1,040 from line 4a, \$100 from line 7c, and (\$20) from line 8. Stated another way, Part I, line 11, includes the entire \$1,000 net income of P, measured before recognition of the intercompany interest income from DS1 and the consolidation of DS1 operations, plus the entire \$140 net income of DS1, measured before interest expense to P, less the minority interest ownership of \$20 in DS1's separate net income (\$100). The PDS consolidated U.S. income tax group is required to include on the attached supporting schedule for Part I, line 8, the details of the adjustment to the minority interest in the net income of DS1, but is not required to report the offsetting adjustment to the intercompany elimination of interest income and interest expense (though it is permitted to do so).

III. Specific Instructions for Parts II and III

For consolidated U.S. income tax returns, file supporting schedules for each includible corporation. See *Consolidated return* in the Instructions for Form 1120.

General Format of Parts II and III

Check the applicable box(es) at the top of pages 2 and 3 of Schedule M-3 to indicate whether the Schedule M-3 is for the: (1) Consolidated group; (2) Parent corporation; (3) Consolidated eliminations; (4) Subsidiary corporation; or (5) Mixed 1120/L/PC group by checking the appropriate box. Also check the applicable box to indicate whether the Schedule M-3 is for a sub-consolidated: (6) 1120 group; or (7) 1120 eliminations.

For each line item in Parts II and III, report in column (a) the amount of net income (loss) included in Part I, line 11, and report in column (d) the amount included in taxable income on Form 1120, page 1, line 28.

Note: A schedule or explanation may be attached to any line even if none is required.

When to Complete Columns (a) and (d)

A corporation is not required to complete columns (a) and (d) of Parts II and III for the first tax year the corporation is required to file Schedule M-3. However, the corporation must complete columns (a) and (d) of Parts II and III for all tax years subsequent to the first tax year the corporation is required to file Schedule M-3. For example, if a corporation was required to file Schedule M-3 as a member of a U.S. consolidated tax group and the corporation leaves the U.S. consolidated tax group, the corporation is required to complete Schedule M-3 in its entirety in any succeeding tax year that the corporation is required to complete Schedule M-3. However, if the corporation joins in filing a different consolidated U.S. income tax return, then the corporation must complete its Schedule M-3 in its entirety in any year that the U.S. consolidated tax group must complete its Schedule M-3 in its entirety.

If, for any tax year (or tax years) prior to the first tax year a corporation is required to file Schedule M-3, a corporation voluntarily files Schedule M-3 in lieu of Schedule M-1, then, in those voluntary filing years, the corporation is not required to complete columns (a) and (d) of Parts II and III. In addition, in the first tax year the corporation is required to file Schedule M-3 the corporation is not required to complete columns (a) and (d) of Parts II and III.

If a corporation that is not a mixed group chooses not to complete columns (a) and (d) of Parts II and III in the first tax year the corporation is required to file Schedule M-3 (or in any year in which the corporation voluntarily files Schedule M-3), then Part II, line 30, is reconciled by the corporation in the following manner:

1. Report the amount from Part I, line 11, on Part II, line 30, column (a);
2. Leave blank Part II, lines 1 through 29, columns (a) and (d);
3. Leave blank Part III, columns (a) and (d); and
4. Report on Part II, line 30, column (d), the sum of Part II, line 30, columns (a), (b), and (c).

In the case of a U.S. consolidated tax group that is not a mixed group, the reconciliation described in the preceding paragraph must be performed by each member of the U.S. consolidated tax group. However, because Part I must be completed only once on the consolidated Schedule M-3 by the parent corporation of the U.S. consolidated tax group, the amount reported on Part II, line 30, column (a), by each member of the U.S. consolidated tax group on its respective Schedule M-3 is the amount attributable to that member that is reported on the consolidated Schedule M-3, Part I, line 11, completed by the parent corporation. Accordingly, the amount reported on Part II, line 30, columns (a) through (d) of the consolidated Schedule M-3, is the sum of the amounts reported by each member of the U.S. consolidated tax group on its respective Schedule M-3 (including a Schedule M-3 for consolidation eliminations, if necessary). Note that the amount reported on Part II, line 30, column (a), of the consolidated Schedule M-3 must equal the amount reported on Part I, line 11, of the consolidated Schedule M-3, and that the amount reported on Part II, line 30, column (d), of the consolidated Schedule M-3 must equal the amount reported on the consolidated Form 1120, page 1, line 28.

When to Complete Columns (b) and (c)

Columns (b) and (c) of Parts II and III must be completed for any tax year for which the corporation files Schedule M-3.

For any item of income, gain, loss, expense, or deduction for which there is a difference between columns (a) and (d), the portion of the difference that is temporary must be entered in column (b) and the portion of the difference that is permanent must be entered in column (c).

If financial statements are prepared by the corporation in accordance with generally accepted accounting principles (GAAP), differences that are treated as temporary for GAAP must be reported in column (b) and differences that are permanent (that is, not temporary for GAAP) must be reported in column (c). Generally, pursuant to GAAP, a temporary difference affects (creates, increases, or decreases) a deferred tax asset or liability.

If the corporation does not prepare financial statements, or the financial statements are not prepared in accordance with GAAP, report in column (b) any difference that the corporation believes will reverse in a future tax year (that is, have an opposite effect on taxable income in a future tax year (or years) due to the difference in timing of recognition for financial accounting and U.S. federal income tax purposes) or is the reversal of such a difference that arose in a prior tax year. Report in column (c) any difference that the corporation believes will not reverse in a future tax year (and is not the reversal of such a difference that arose in a prior tax year).

If the corporation is unable to determine whether a difference between column (a) and column (d) for an item will reverse in a future tax year or is the reversal of a difference that arose in a prior tax year, report the difference for that item in column (c).

Example 5.

For the 2009, 2010, and 2011 tax years, corporation A has total consolidated assets on the last day of the tax year as reported on Schedule L, line 15, column (d), of \$8 million, \$11 million, and \$12 million, respectively. A is required to file Schedule M-3 for its 2010 and 2011 tax years.

For its 2009 tax year, A voluntarily files Schedule M-3 in lieu of Schedule M-1 and does not complete columns (a) and (d) of Parts II and III.

For A's 2010 tax year, the first tax year that A is required to file Schedule M-3, A is only required to complete Part I and columns (b) and (c) of Parts II and III.

For A's 2011 tax year, A is required to complete Schedule M-3 in its entirety.

Example 6.

Corporation B is a U.S. publicly traded corporation that files a consolidated U.S. income tax return and prepares consolidated GAAP financial statements. In prior years, B acquired intellectual property (IP) and goodwill through several corporate acquisitions. The IP is amortizable for both U.S. income tax and financial statement purposes. In the current year, B's annual amortization expense for IP is \$9,000 for U.S. income tax purposes and \$6,000 for financial statement purposes. In its financial statements, B treats the difference in IP amortization as a temporary difference. The goodwill is not amortizable for U.S. income tax purposes and is subject to impairment for financial statement purposes. In the current year, B records an impairment charge on the goodwill of \$5,000. In its financial statements, B treats the goodwill impairment as a permanent difference. B must report the amortization attributable to the IP on Part III, line 28, and report \$6,000 in column (a), a temporary difference of \$3,000 in column (b), and \$9,000 in column (d). B must report the goodwill impairment on Part III, line 26, and report \$5,000 in column (a), a permanent difference of (\$5,000) in column (c), and \$0 in column (d).

IV. Reporting Requirements for Parts II and III

Except for mixed group consolidation, the number of Parts II should equal the number of Parts III filed by the corporation.

General Reporting Requirements

If an amount is attributable to a reportable transaction described in Regulations section 1.6011-4(b) (other than a transaction described in Regulations section 1.6011-(4)(b)(6) relating to significant book-tax differences), the amount must be reported in columns (a), (b), (c), and (d), as applicable, of Part II, line 12, Items relating to reportable transactions, regardless of whether the amount would otherwise be reported on Part II or Part III of Schedule M-3. Thus, if a taxpayer files Form 8886, Reportable Transaction Disclosure Statement, the amounts attributable to that reportable transaction must be reported on Part II, line 12.

A corporation is required to report in column (a) of Parts II and III the amount of any item specifically listed on Schedule M-3 that is in any manner included in the corporation's current year financial statement net income (loss) or in an income or expense account maintained in the corporation's books and records, even if there is no difference between that amount and the amount included in taxable income unless (a) otherwise provided in these instructions or (b) the amount is attributable to a reportable transaction described in Regulations section 1.6011-4(b) other than a transaction described in Regulations section 1.6011-(4)(b)(6) (relating to significant book-tax differences) and is therefore reported on Part II, line 12. For example, with the exception of interest income reflected on a Schedule K-1 received by a corporation as a result of the corporation's investment in a partnership or other pass-through entity, all interest income included on Part I, line 11, whether from unconsolidated affiliated companies, third parties, banks, or other entities, whether from foreign or domestic sources, whether taxable or exempt from tax and whether classified as some other type of income for U.S. income tax purposes (such as dividends), must be included on Part II, line 13, column (a). Likewise,

all fines and penalties included in Part I, line 11, paid to a government or other authority for the violation of any law for which fines or penalties are assessed must be included on Part III, line 12, column (a), regardless of the government authority that imposed the fines or penalties, regardless of whether the fines or penalties are civil or criminal, regardless of the classification, nomenclature, or terminology attached to the fines or penalties by the imposing authority in its actions or documents.

If a corporation would be required to report in column (a) of Parts II and III the amount of any item specifically listed on Schedule M-3 in accordance with the preceding paragraph, except that the corporation has capitalized the item of income or expense and reports the amount in its financial statement balance sheet or in asset and liability accounts maintained in the corporation's books and records, the corporation must report the proper tax treatment of the item in columns (b), (c), and (d), as applicable.

Furthermore, in applying the two preceding paragraphs, a corporation is required to report in column (a) of Parts II and III the amount of any item specifically listed on Schedule M-3 that is included in the corporation's financial statements or exists in the corporation's books and records, regardless of the nomenclature associated with that item in the financial statements or books and records. Accurate completion of Schedule M-3 requires reporting amounts according to the substantive nature of the specific line items included in Schedule M-3 and consistent reporting of all transactions of like substantive nature that occurred during the tax year. For example, all expense amounts that are included in the financial statements or exist in the books and records that represent some form of "Bad debt expense," must be reported on Part III, line 32, in column (a), regardless of whether the amounts are recorded or stated under different nomenclature in the financial statements or the books and records such as: "Provision for doubtful accounts;" "Expense for uncollectible notes receivable;" or "Impairment of trade accounts receivable." Likewise, as stated in the preceding paragraph, all fines and penalties must be included on Part III, line 12, column (a), regardless of the terminology or nomenclature attached to them by the corporation in its books and records or financial statements.

With limited exceptions, Part II includes lines for specific items of income, gain, or loss (income items). (See Part II, lines 1 through 24.) If an income item is described in Part II, lines 1 through 24, report the amount of the item on the applicable line, regardless of whether there is a difference for the item. If there is a difference for the income item, or only a portion of the income item has a difference and a portion of the item does not have a difference, and the item is not described in Part II, lines 1 through 24, report and describe the entire amount of the item on Part II, line 25.

With limited exceptions, Part III includes lines for specific items of expense or deduction (expense items). (See Part III, lines 1 through 34.) If an expense item is described on Part III, lines 1 through 34, report the amount of the item on the applicable line, regardless of whether there is a difference for the item. If there is a difference for the expense item, or only a portion of the expense item has a difference and a portion of the item does not have a difference and the item is not described in Part III, lines 1 through 34, report and describe the entire amount of the item on Part III, line 35.

If there is no difference between the financial accounting amount and the taxable amount of an entire item of income, loss, expense, or deduction and the item is not described or included in Part II, lines 1 through 25, or Part III, lines 1 through 35, report the entire amount of the item in column (a) and (d) of Part II, line 28.

Special instructions for Part II, lines 25 and 28, and Part III, line 37. Whether a given income (loss) item is reported on Part II, line 25, or on Part II, line 28, or a given expense/deduction item on Part III, line 37, or on Part II, line 28, is determined separately by each member of the U.S. consolidated tax group and not at the U.S. consolidated tax group level. For example, U.S. corporation P has two subsidiaries, A and B, that are included in P's consolidated financial statements and in P's consolidated U.S. income tax return. For financial statement purposes, P, A, and B recognize real estate tax expense when accrued. For U.S. income tax purposes, P and A recognize such expense consistent with the method used for financial statement purposes, whereas B recognizes such deduction based on a method different from that used for financial statement purposes. P and A must report this expense/deduction in column (a) and (d) on Part II, line 28. B must report the following on Part III, line 37: in column (a), B's expense recognized in the financial statements when accrued; in column (d), B's real estate tax expense recognized for U.S. income tax purposes; and in column (b) or (c), as applicable, the difference between B's real estate tax expense in its financial statements and its real estate tax deduction recognized for U.S. taxable income purposes.

Separately stated and adequately disclosed. Each difference reported in Parts II and III must be separately stated and adequately disclosed. In general, a difference is adequately disclosed if the difference is labeled in a manner that clearly identifies the item or transaction from which the difference arises. For further guidance about adequate disclosure, see Regulations section 1.6662-4(f), Rev. Proc. 2006-48, 2006-47 I.R.B. 934. If a specific item of income, gain, loss, expense, or deduction is described on Part II, lines 9 through 24, or Part III, lines 1 through 34, and the line does not indicate to "attach schedule" or "attach details," and the specific instructions for the line do not call for an attachment of a schedule or statement, then the item is considered separately stated and adequately disclosed if the item is reported on the applicable line and the amount(s) of the item(s) are reported in the applicable columns of the applicable line. See the instructions for Part II, lines 1 through 8, for specific additional information required to be provided for amounts reported for these particular lines.

Note. A schedule or explanation may be attached to any line even if none is required.

Except as otherwise provided, differences for the same item must be combined or netted together and reported as one amount on the applicable line of Schedule M-3. However, differences for separate items must not be combined or netted together. Each item (and corresponding amount attributable to that item) must be separately stated and adequately disclosed on the applicable line of Schedule M-3 or any schedule required to be attached, even if the amounts are below a certain dollar amount.

Required schedules for Part II, line 25, and Part III, line 37. A separate schedule must be attached to Schedule M-3 (Form 1120) that includes a detailed description of each item and adjustment entered on Part II, line 25, and Part III, line 37.

The description for each amount entered in column (a) must be readily identifiable to the name of the account in the financial statements or books and records of the taxpayer,

under which the amount in column (a) was recorded in the accounting records. Also, the description for each amount entered in column (a) must include detailed information supporting each adjustment reported in columns (b) and (c), including how the adjustment is identified in the accounting records. The entire description is considered the tax description for the amount reported in column (d) for each item reported on Part II, line 25, or Part III, line 37.

Each description should adequately describe all four columns of Part II, line 25, or Part III, line 37. If additional information is required to provide an acceptable description, provide a acceptable description would be supporting attachment.

Example 7.

Corporation C is a calendar year taxpayer that placed in service ten depreciable fixed assets in 2004. C was required to file Schedule M-3 for its 2009 tax year and is required to file Schedule M-3 for its 2010 tax year. C's total depreciation expense for its 2010 tax year for five of the assets is \$50,000 for income statement purposes and \$70,000 for U.S. income tax purposes. C's total annual depreciation expense for its 2010 tax year for the other five assets is \$40,000 for income statement purposes and \$30,000 for U.S. income tax purposes. In its financial statements, C treats the differences between financial statement and U.S. income tax depreciation expense as giving rise to temporary differences that will reverse in future years. C must combine all of its depreciation adjustments. Accordingly, C must report on Part III, line 31, for its 2010 tax year income statement depreciation expense of \$90,000 in column (a), a temporary difference of \$10,000 in column (b), and U.S. income tax depreciation expense of \$100,000 in column (d).

Example 8.

Corporation D is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax year and is required to file Schedule M-3 for its 2010 tax year. On December 31, 2010, D establishes three reserve accounts in the amount of \$100,000 for each account. One reserve account is an allowance for accounts receivable that are estimated to be uncollectible. The second reserve is an estimate of a settlement D may have to pay as a result of coupons outstanding. The third reserve is an estimate of future warranty expenses. In its financial statements, D treats the three reserve accounts as giving rise to temporary differences that will reverse in future years. The three reserves are expenses in D's 2010 financial statements but are not deductions for U.S. income tax purposes in 2010. D must not combine the Schedule M-3 differences for the three reserve accounts. D must report the amounts attributable to the allowance for uncollectible accounts receivable on Part III, line 32, and must separately state and adequately disclose the amounts attributable to each of the other two reserves for coupons outstanding and the warranty costs on a required, attached schedule that supports the amounts at Part III, line 37. D must also provide a description for each reserve that meets the requirements for Part III, line 37, discussed earlier.

Note. There is no need to add the title of the reserve account to the description if the account name for the amount in column (a) is already part of the adjustment description.

Example 9.

Corporation E is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax year and is required to file Schedule M-3 for its 2010 tax year. On January 2, 2010, E establishes an allowance for uncollectible accounts receivable (bad debt reserve) of \$100,000. During 2010, E increased the reserve by \$250,000 for additional accounts receivable that may become uncollectible. Additionally, during 2010 E decreases the reserve by \$75,000 for accounts receivable that were discharged in bankruptcy during 2010. The balance in the reserve account on December 31, 2010, is \$275,000. The \$100,000 amount to establish the reserve account and the \$250,000 to increase the reserve account are expenses on E's 2010 financial statements but are not deductible for U.S. income tax purposes in 2010. However, the \$75,000 decrease to the reserve is deductible for U.S. income tax purposes in 2010. In its financial statements, E treats the reserve account as giving rise to a temporary difference that will reverse in future tax years. E must report on Part III, line 32, for its 2010 tax year income statement bad debt expense of \$350,000 in column (a), a temporary difference of (\$275,000) in column (b), and U.S. income tax bad debt expense of \$75,000 in column (d).

Example 10.

Corporation F is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax year and is required to file Schedule M-3 for its 2010 tax year. During 2010, F incurs \$200 of meals and entertainment expenses that F deducts in computing net income per the income statement. \$50 of the \$200 is subject to the 50% limitation under section 274(n). In its financial statements, F treats the limitation on deductions for meals and entertainment as a permanent difference. Because meals and entertainment expenses are specifically described in Part III, line 11, F must report all of its meals and entertainment expenses on this line, regardless of whether there is a difference. Accordingly, F must report \$200 in column (a), \$25 in column (c), and \$175 in column (d). F must not report the \$150 of meals and entertainment expenses that are deducted in F's financial statement net income and are fully deductible for U.S. income tax purposes on Part II, line 28, Other items with no differences, and the \$50 subject to the limitation under section 274(n) on Part III, line 11.

V. Part II. Reconciliation of Net Income (Loss) Per Income Statement of Includible Corporations With Taxable Income Per Return**Lines 1 Through 8. Additional Information for Each Corporation**

For any item reported on Part II, lines 1, 3 through 6, or 8, attach a supporting schedule that provides the name of the entity for which the item is reported, the type of entity (corporation, partnership, etc.), the entity's EIN (if applicable), and the item amounts for columns (a) through (d). See the instructions for Part II, lines 2 and 7, for the specific information required for those particular lines.

Line 1. Income (Loss) From Equity Method Foreign Corporations

Report on line 1, column (a), the financial income (loss) included in Part I, line 11, for any foreign corporation accounted for on the equity method and remove such amount in column (b) or (c), as applicable. Report the amount of dividends received and other taxable amounts received or includible from foreign corporations on Part II, lines 2 through 5, as applicable.

Line 2. Gross Foreign Dividends Not Previously Taxed

Except as otherwise provided in this paragraph, report on line 2, column (d), the amount (before any withholding tax) of any foreign dividends included in current year taxable income on Form 1120, page 1, line 28 and report on line 2, column (a), the amount of dividends from any foreign corporation included in Part I, line 11. Do not report on Part I, line 2, any amounts that must be reported on Part II, lines 3 or 4, or dividends that were previously taxed and must be reported on Part II, line 5. (See the instructions below for Part II, lines 3, 4 and 5).

For any dividends reported on Part II, line 2, that are received on a class of voting stock of which the corporation directly or indirectly owned 10% or more of the outstanding shares of that class at any time during the tax year, report on an attached supporting schedule the name of the dividend payer, the payer's EIN (if applicable), the class of voting stock on which the dividend was paid, the percentage of the class directly or indirectly owned, and the item amounts for columns (a) through (d).

Line 3. Subpart F, QEF, and Similar Income Inclusions

Report on line 3, column (d), the amount included in taxable income under section 951 (relating to Subpart F), gains or other income inclusions resulting from elections under sections 1291(d)(2) and 1298(b)(1), and any amount included in taxable income pursuant to section 1293 (relating to qualified electing funds). The amount of Subpart F income corresponds to the total of the amounts reported by the corporation on line 6, Schedule I, of all Forms 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. The amount of qualified electing fund income corresponds to the total of the amounts reported by the corporation on line 3(a), Part II, of all Forms 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.

Also include on line 3 PFIC mark-to-market gains and losses under section 1296. Do not report such gains and losses on Part II, line 16.

Line 4. Section 78 Gross-Up

Report on line 4, column (d), the amount of any section 78 gross-up not included in column (d) of Part II, lines 9, 10, and 11. The section 78 gross-up amount on this line 4 must correspond to the total section 78 gross-up amounts reported by the corporation on all Forms 1118, Foreign Tax Credit—Corporations excluding the amounts reporting in column (d) of Part II, lines 9, 10, and 11.

Line 5. Gross Foreign Distributions Previously Taxed

Report on line 5, column (a), any distributions received from foreign corporations that were included in Part I, line 11, and that were previously taxed for U.S. income tax purposes. For example, include in column (a) amounts that are excluded from taxable income under sections 959 and 1293(c). Remove such amount in column (b) or (c), as applicable. Report the full amount of the distribution before any withholding tax. Since previously taxed foreign distributions are not currently taxable, line 5, column (d) is shaded. (Also, see instructions above for Part II, line 2.)

Line 6. Income (Loss) From Equity Method U.S. Corporations

Report on line 6, column (a), the income statement income (loss) included in Part I, line 11, for any U.S. corporation accounted for on the equity method and remove such amount in column (b) or (c), as applicable. Report on Part II, line 7, dividends received from any U.S. corporation accounted for on the equity method.

Line 7. U.S. Dividends Not Eliminated in Tax Consolidation

Report on line 7, column (a), the amount of dividends included in Part I, line 11 that were received from any U.S. corporation. Report on line 7, column (d), the amount of any U.S. dividends included in taxable income on Form 1120, page 1, line 28.

Usually, the amounts included on line 7, columns (a) and (d) include only dividends received from U.S. corporations that are not included in the U.S. consolidated tax group because intercompany dividends received from includible corporations listed on Form 851 are eliminated for financial accounting purposes and for the calculation of U.S. taxable income. In the case of an insurance company included in the consolidated U.S. income tax return that is required to report intercompany dividends received as part of statutory accounting net income, include such intercompany dividends on Part II, line 7 column (a) and the taxable amount of those dividends on Part II, line 7 column (d). (For insurance companies included in the consolidated U.S. income tax return, see the instructions for Part I, lines 10 and 11.)

For any intercompany dividends (dividends received from includible corporations listed on Form 851) included on Part II, line 7, report on an attached supporting schedule: (1) the name of the dividend payer, (2) the payer's EIN, (3) the class of stock or security on which the dividends were paid, (4) the amount of any net adjustment included on Part I, line 10a, for such dividends, and (5) the item amounts for columns (a) through (d).

For any dividends reported on Part II, line 7, that are not intercompany dividends that are received on classes of voting stock in which the corporation directly or indirectly owned 10% or more of the outstanding shares of that class at any time during the tax year, report on an attached supporting schedule for Part II, line 7: (1) the name of the dividend payer, (2) the class of voting stock on which the dividend was paid, (3) the payer's EIN (if applicable), (4) the percentage of the class directly or indirectly owned, and (5) the item amounts for columns (a) through (d).

Line 8. Minority Interest for Includible Corporations

Report on line 8, column (a), the minority interest included in the income statement income (loss) on Part I, line 11, for any member of the U.S. consolidated tax group that is less than 100% owned.

Example 11.

Corporation G is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax year and is required to file Schedule M-3 for its 2010 tax year. G owns 90% of the stock of U.S. corporation DS1. G files a consolidated U.S. income tax return with DS1 as the GDS1 U.S. consolidated group. G prepares certified GAAP financial statements for the consolidated financial statement group consisting of G and DS1. G has no net income of its own, and G does not report its equity interest in the income of DS1 on its separate financial statements. DS1 has financial statement net income (before minority interests) and taxable income of \$1,000 (\$2,500 of revenue less \$1,500 cost of goods sold).

On the consolidated Schedule M-3, Part I, line 4 and on line 11, the U.S. consolidated tax group GDS1 must report \$900 of financial statement net income (\$1,000 net income less \$100 minority interest).

The GDS1 group must prepare one consolidated Schedule M-3, Parts II and III and three additional Schedules M-3, Parts II and III: one for G, one for DS1, and one for consolidation eliminations.

On the Schedule M-3, Parts II and III for DS1, \$1,000 is reported on Part II, line 28 and line 30, in both columns (a) and (d). On G's Schedule M-3, Parts II and III, zero is reported on Part II, line 30, in both columns (a) and (d). On the consolidation eliminations Schedule M-3, Parts II and III, on Part II, line 8 and line 30, the minority interest elimination for the U.S. consolidated tax group is reported as (\$100) in column (a), \$100 in column (c), and \$0 in column (d).

On the Schedule M-3, Parts II and III for the U.S. consolidated tax group, on Part II, line 8, (\$100) is reported in column (a), \$100 in column (c), and \$0 in column (d). On Part II, line 28, the U.S. consolidated tax group reports \$1,000 in both columns (a) and (d). As a result, financial statement net income on Part II, line 30, column (a), will total \$900, net permanent differences on Part II, line 30, column (c), will total \$100, and taxable income on line 30, column (d), will total \$1,000.

Line 9. Income (Loss) From U.S. Partnerships and Line 10. Income (Loss) From Foreign Partnerships

For any interest owned by the corporation or a member of the U.S. consolidated tax group that is treated as an investment in a partnership for U.S. income tax purposes (other than an interest in a disregarded entity), report amounts on Part II, line 9 or 10, as described below:

1. In column (a) the sum of the corporation's distributive share of income or loss from a U.S. or foreign partnership that is included in Part I, line 11;

2. In column (b) or (c), as applicable, except for amounts described in item 4, below, the sum of all differences, if any, attributable to the corporation's distributive share of income or loss from a U.S. or foreign partnership; and
3. In column (d), except for amounts described in item 4, below, the sum of all amounts of income, gain, loss, or deduction attributable to the corporation's distributive share of income or loss from a U.S. or foreign partnership (i.e., the sum of all amounts reportable on the corporation's Schedule(s) K-1 received from the partnership (if applicable)), without regard to any limitations computed at the partner level (e.g., limitations on utilization of charitable contributions, capital losses, and interest expense).
4. Do not report on Part II, line 9 or 10, as applicable, any portion of a corporation's deduction under section 199 even if some or all of the corporation's deduction under section 199 is attributable to a partnership interest held by the corporation. A corporation must report its deduction only on Part III, line 22.

For each partnership reported on line 9 or 10, attach a supporting schedule that provides the name, EIN (if applicable), end of year profit-sharing percentage (if applicable), end of year loss-sharing percentage (if applicable), and the amount reported in column (a), (b), (c), or (d) of lines 9 or 10, as applicable.

Example 12.

U.S. corporation H is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax year and is required to file Schedule M-3 for its 2010 tax year. H has an investment in a U.S. partnership USP. H prepares financial statements in accordance with GAAP. In its financial statements, H treats the difference between financial statement net income and taxable income from its investment in USP as a permanent difference. For its 2010 tax year, H's financial statement net income includes \$10,000 of income attributable to its share of USP's net income. H's Schedule K-1 from USP reports \$5,000 of ordinary income, \$7,000 of long-term capital gains, \$4,000 of charitable contributions, and \$200 of section 179 expense. H must report on Part II, line 9, \$10,000 in column (a), a permanent difference of (\$2,200) in column (c), and \$7,800 in column (d).

Example 13.

Same facts as Example 12 except that corporation H's charitable contribution deduction is wholly attributable to its partnership interest in USP and is limited to \$90 pursuant to section 170(b)(2) due to other investment losses incurred by H. In its financial statements, H treated this limitation as a temporary difference. H must not report the charitable contribution limitation of \$3,910 (\$4,000 - \$90) on Part II, line 9. H must report the limitation on Part III, line 21, and report the disallowed charitable contributions of (\$3,910) in columns (b) and (d).

Line 11. Income (Loss) From Other Pass-Through Entities

For any interest in a pass-through entity (other than an interest in a partnership reportable on Part II, line 9 or 10, as applicable) owned by a member of the U.S. consolidated tax group (other than an interest in a disregarded entity), report the following on line 11:

1. In column (a) the sum of the corporation's distributive share of income or loss from the pass-through entity that is included in Part I, line 11;
2. In column (b) or (c), as applicable, except for amounts described in item 4, the sum of all differences, if any, attributable to the pass-through entity; and
3. In column (d), except for amounts described in item 4, below, the sum of all taxable amounts of income, gain, loss, or deduction reportable on the corporation's Schedules K-1 received from the pass-through entity (if applicable).
4. Do not report on Part II, line 11, any portion of a corporation's deduction even if some or all of the corporation's deduction is attributable to an interest in a pass-through entity held by the corporation. A corporation must report this deduction only on Part III, line 22.

For each pass-through entity reported on line 11, attach a supporting schedule that provides that entity's name, EIN (if applicable), the corporation's end of year profit-sharing percentage (if applicable), the corporation's end of year loss-sharing percentage (if applicable), and the amounts reported by the corporation in column (a), (b), (c), or (d) of line 11, as applicable.

Line 12. Items Relating to Reportable Transactions

Any amounts attributable to any reportable transactions (as described in Regulations section 1.6011-4) must be included on Part II, line 12, regardless of whether the difference, or differences, would otherwise be reported elsewhere in Part II or Part III. Thus, if a taxpayer files Form 8886 for any reportable transaction described in Regulations section 1.6011-4, the amounts attributable to that reportable transaction must be reported on Part II, line 12. In addition, all income and expense amounts attributable to a reportable transaction must be reported on Part II, line 12, columns (a) and (d) even if there is no difference between the financial statement amounts and the taxable amounts.

Each difference attributable to a reportable transaction must be separately stated and adequately disclosed. A corporation will be considered to have separately stated and adequately disclosed a reportable transaction on line 12 if the corporation sequentially numbers each Form 8886 and lists by identifying number on the supporting schedule for Part II, line 12, each sequentially numbered reportable transaction and the amounts required for Part II, line 12, columns (a) through (d).

In lieu of the requirements of the preceding paragraph, a corporation will be considered to have separately stated and adequately disclosed a reportable transaction if the corporation attaches a supporting schedule that provides the following for each reportable transaction:

1. A description of the reportable transaction disclosed on Form 8886 for which amounts are reported on Part II, line 12;
2. The name and tax shelter registration number, if applicable, as reported on lines 1a and 1b, respectively, of Form 8886; and
3. The type of reportable transaction (i.e., listed transaction, confidential transaction, transaction with contractual protection, etc.) as reported on line 2 of Form 8886.

If a transaction is a listed transaction described in Regulations section 1.6011-4(b)(2), the description also must include the description provided on line 3 of Form 8886. In addition, if the reportable transaction involves an investment in the transaction through another entity such as a partnership, the description must include the name and EIN (if applicable) of that entity as reported on line 5 of Form 8886.

Example 14.

Corporation J is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax year and is required to file Schedule M-3 for its 2010 tax year. J incurred seven different abandonment losses during its 2010 tax year. One loss of \$12 million results from a reportable transaction described in Regulations section 1.6011-4(b)(5), another loss of \$5 million results from a reportable transaction described in Regulations section 1.6011-4(b)(4), and the remaining five abandonment losses are not reportable transactions. J discloses the reportable transactions giving rise to the \$12 million and \$5 million losses on separate Forms 8886 and sequentially numbers them X1 and X2, respectively. J must separately state and adequately disclose the \$12 million and \$5 million losses on Part II, line 12. The \$12 million loss and the \$5 million loss will be adequately disclosed if J attaches a supporting schedule for line 12 that lists each of the sequentially numbered forms, Form 8886-X1 and Form 8886-X2, and with respect to each reportable transaction reports the appropriate amounts required for Part II, line 12, columns (a) through (d). Alternatively, J's disclosures will be adequate if the description provided for each loss on the supporting schedule includes the names and tax shelter registration numbers, if any, disclosed on the applicable Form 8886, identifies the type of reportable transaction for the loss, and reports the appropriate amounts required for Part II, line 12, columns (a) through (d). J must report the losses attributable to the other five abandonment losses on Part II, line 23e, regardless of whether a difference exists for any or all of those abandonment losses.

Example 15.

Corporation K is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax year and is required to file Schedule M-3 for its 2010 tax year. K enters into a transaction with contractual protection that is a reportable transaction described in Regulations section 1.6011-4(b)(4). This reportable transaction is the only reportable transaction for K's 2010 tax year and results in a \$7 million capital loss for both financial accounting purposes and U.S. income tax purposes. Although the transaction does not result in a difference, K is required to report on Part II, line 12, the following amounts: (\$7 million) in column (a), zero in columns (b) and (c), and (\$7 million) in column (d). The transaction will be adequately disclosed if K attaches a supporting schedule for line 12 that: (a) sequentially numbers the Form 8886 and refers to the sequentially-numbered Form 8886-X1, and (b) reports the applicable amounts required for line 12, columns (a) through (d). Alternatively, the transaction will be adequately disclosed if the supporting statement for line 12 includes a description of the transaction, the name and tax shelter registration number, if any, and the type of reportable transaction disclosed on Form 8886.

Line 13. Interest Income

Report on Part II, line 13, column (a), the total amount of interest income included on Part I, line 11, and report on Part II, line 13, column (d), the total amount of interest income included on Form 1120, page 1, line 28, that is not required to be reported elsewhere on Schedule M-3. In columns (b) or (c), as applicable, adjust for any amounts treated for U.S. income tax purposes as interest income that are treated as some other form of income for financial accounting purposes, or vice versa. For example, adjustments to interest income resulting from adjustments made in accordance with the instructions for Part II, line 18, should be made in columns (b) and (c) of this line 13.

Complete Part II of Form 8916-A. Enter the amounts from line 6, columns (a) through (d) of Form 8916-A, on Schedule M-3, part II, line 13, columns (a) through (d), as applicable. Attach Form 8916-A.

Do not report on this line 13 or include on form 8916-A amounts reported in accordance with the instructions for Part II, lines 9, 10, 11, 12, and 22.

Line 14. Total Accrual to Cash Adjustment

This line is completed by a corporation that prepares financial statements (or books and records) using an overall accrual method of accounting and uses an overall cash method of accounting for U.S. income tax purposes (or vice versa). With the exception of amounts required to be reported on Part II, line 12, the corporation must report on Part II, line 14, a single amount net of all adjustments attributable solely to the use of the different overall methods of accounting (e.g., adjustments related to accounts receivable, accounts payable, compensation, accrued liabilities, etc.), regardless of whether a separate line on Schedule M-3 corresponds to an item within the accrual to cash reconciliation. Differences not attributable to the use of the different overall methods of accounting must be reported on the appropriate lines of Schedule M-3 (e.g., a depreciation difference must be reported on Part III, line 31).

Example 16.

Corporation L is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax year and is required to file Schedule M-3 for its 2010 tax year. L prepares financial statements in accordance with GAAP using an overall accrual method of accounting. L uses an overall cash method of accounting for U.S. income tax purposes. L's financial statements for the year ending December 31, 2010, report accounts receivable of \$35,000, an allowance for bad debts of \$10,000, and accounts payable of \$17,000 related to current year acquisition and reorganization legal and accounting fees. In addition, for L's year ending December 31, 2010, L reported financial statement depreciation expense of \$15,000 and depreciation for U.S. income tax purposes of \$25,000. For L's 2010 tax year using an overall cash method of accounting, L does not recognize the \$35,000 of revenue attributable to the accounts receivable, cannot deduct the \$10,000 allowance for bad debt, and cannot deduct the \$17,000 of accounts payable. In its financial statements, L treats both the difference in overall accounting methods used for financial statement and U.S. income tax purposes and the difference in depreciation expense as temporary differences. L must combine all adjustments attributable to the differences related to the overall accounting methods on Part II, line 14. As a result, L must report on Part II, line 14, \$8,000 in column (a) (\$35,000 - \$10,000 - \$17,000), (\$8,000) in column (b), and zero in column (d). L must not report the accrual to cash adjustment attributable to the legal and accounting fees on Part III, line 24, Current year acquisition and reorganization legal and accounting fees. Because the difference in depreciation expense does not relate to the use of the cash or accrual method of accounting, L must report the depreciation difference on Part III, line 31, and report \$15,000 in column (a), \$10,000 in column (b), and \$25,000 in column (d).

Line 15. Hedging Transactions

Report on line 15, column (a), the net gain or loss from hedging transactions included on Part I, line 11. Report in column (d) the amount of taxable income from hedging transactions as defined in section 1221(b)(2). Use columns (b) and (c) to report all differences caused by treating hedging transactions differently for financial accounting purposes and for U.S. income tax purposes. For example, if a portion of a hedge is considered ineffective under GAAP but still is a valid hedge under section 1221(b)(2), the difference must be reported on line 15. The hedge of a capital asset, which is not a valid hedge for U.S. income tax purposes but may be considered a hedge for GAAP purposes, must also be reported here.

Report hedging gains and losses computed under the mark-to-market method of accounting on line 15 and not on Part II, line 16.

Report any gain or loss from inventory hedging transactions on line 15 and not on Part II, line 17.

Line 16. Mark-to-Market Income (Loss)

Report on line 16 any amount representing the mark-to-market income or loss for any securities held by a dealer in securities, a dealer in commodities having made a valid election under section 475(e), or a trader in securities or commodities having made a

valid election under section 475(f). "Securities" for these purposes are securities described in section 475(c)(2) and section 475(e)(2). "Securities" do not include any items specifically excluded from sections 475(c)(2) and 475(e)(2), such as certain contracts to which section 1256(a) applies.

Report hedging gains and losses computed under the mark-to-market method of accounting on Part II, line 15, and not on line 16.

Line 17. Cost of Goods Sold

Report on line 17 any amounts deducted as part of cost of goods sold during the tax year, regardless of whether the amounts would otherwise be reported elsewhere in Part II or Part III.

Examples of amounts that must be included as cost of goods sold items are amounts attributable to inventory valuation, for example, amounts attributable to cost-flow assumptions, additional costs required to be capitalized to ending inventory (including depreciation) such as section 263A costs, inventory shrinkage accruals, inventory obsolescence reserves, and lower of cost or market write-downs.

Complete Part I of Form 8916-A. Enter the amounts from line 8, columns (a) through (d) of Form 8916-A, on Schedule M-3, Part II, line 17, columns (a) through (d), as applicable. Attach Form 8916-A.

Note. The entries in columns (a) and (d) of Schedule M-3, line 17, are negative amounts.

Do not report the following on this line 17 or on Form 8916-A:

- Amounts reportable on Part II, line 12;
- Any gain or loss from inventory hedging transactions reportable on Part II, line 15;
- Amounts reportable on Part II, line 18;
- Amounts reportable on Part II, line 21;
- Mark-to-market income or (loss) associated with the inventories of dealers in securities under section 475 reportable on Part II, line 16;
- Section 481(a) adjustments related to cost of goods sold or inventory valuation reportable on Part II, line 19;
- Fines and penalties reportable on Part III, line 12;
- Judgments, damages, awards and similar costs, reportable on Part III, line 13; and
- Amounts included on Part III, line 34.

Example 17.

Corporation C is a calendar year taxpayer that placed in service ten depreciable fixed assets in 2004. C was required to file Schedule M-3 for its 2009 tax year and is required to file Schedule M-3 for its 2010 tax year. C's total depreciation expense for its 2010 tax year for five of the assets is \$50,000 for income statement purposes and \$70,000 for U.S. income tax purposes. C's total annual depreciation expense for its 2010 tax year for the other five assets is \$40,000 for income statement purposes and \$30,000 for U.S. federal income tax purposes. In addition, C incurs \$200 of meals and entertainment expenses that C deducts in computing net income per the income statement. All \$200 of the meals and entertainment expenses is subject to the 50% limitation under section 274(n). In its financial statements, C treats the \$50,000 depreciation and \$100 of the meals and entertainment as other costs in computing cost of goods sold. C must include on Form 9916-A and on Part II, line 17, in column (a), the \$50,000 of depreciation and \$100 of meals and entertainment. C must also include a temporary difference of \$20,000 in column (b) a permanent difference of \$(50) in column (c) and \$70,050 in column (d) (\$70,000 depreciation and \$50 meals and entertainment expenses). In addition, C must report on Part III, line 31, for its 2010 tax year income statement, depreciation expense of \$40,000 in column (a), a temporary difference of \$(10,000) in column (b) and \$30,000 in column (d); and on Part III, line 11, meals and entertainment expense of \$100 in column (a), a permanent difference of \$(50) in column (c), and \$50 in column (d). All other cost of goods sold items would be added to the amounts included on Part II, line 17 detailed in this example and reported on Part II, line 17, in the appropriate columns.

Line 18. Sale Versus Lease (for Sellers and/or Lessors)

Note. Also see the instructions at Part III, line 34, later, for purchasers and/or lessees.

Asset transfer transactions with periodic payments characterized for financial accounting purposes as either a sale or a lease may, under some circumstances, be characterized as the opposite for tax purposes. If the transaction is treated as a lease, the seller/lessor reports the periodic payments as gross rental income and also reports depreciation expense or deduction. If the transaction is treated as a sale, the seller/lessor reports gross profit (sale price less cost of goods sold) from the sale of assets and reports the periodic payments as payments of principal and interest income.

On Part II, line 18, column (a), report the gross profit or gross rental income for financial income purposes for all sale or lease transactions that must be given the opposite characterization for tax purposes. On Part II, line 18, column (d), report the gross profit or gross rental income for federal income tax purposes. Interest income amounts for such transactions must be reported on Part II, line 13, in column (a) or (d), as applicable. Depreciation expense for such transactions must be reported on Part III, line 31, in column (a) or (d), as applicable. Use columns (b) and (c) of Part II, lines 13 and 18, and Part III, line 31, as applicable to report the differences between column (a) and (d).

Example 18.

Corporation M sells and leases property to customers. M is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax year and is required to file Schedule M-3 for its 2010 tax year. For financial accounting purposes, M accounts for each transaction as a sale. For U.S. income tax purposes, each of M's transactions must be treated as a lease. In its financial statements, M treats the difference in the financial accounting and the U.S. income tax treatment of these transactions as temporary. During 2010, M reports in its financial statements \$1,000 of sales and \$700 of cost of goods sold with respect to 2010 lease transactions. M receives periodic payments of \$500 in 2010 with respect to these 2010 transactions and similar transactions from prior years and treats \$400 as principal and \$100 as interest income. For financial income purposes, M reports gross profit of \$300 (\$1,000 - \$700) and interest income of \$100 from these transactions. For U.S. income tax purposes, M reports \$500 of gross rental income (the periodic payments) and (based on other facts) \$200 of depreciation deduction on the property. On its 2010 Schedule M-3, M must report on Part II, line 13, \$100 in column (a), (\$100) in column (b), and zero in column (d). In addition, M must report on Part II, line 18, \$300 of gross profit in column (a), \$200 in column (b), and \$500 of gross rental income in column (d). Lastly, M must report on Part III, line 31, \$200 in column (b) and (d).

Line 19. Section 481(a) Adjustments

With the exception of a section 481(a) adjustment that is required to be reported on Part II, line 12, for reportable transactions, any difference between an income or expense item attributable to an authorized (or unauthorized) change in method of accounting made for U.S. federal income tax purposes that results in a section 481(a) adjustment must be reported on Part II, line 19, regardless of whether a separate line for that income or expense item exists in Part II or Part III.

Example 19.

Corporation N is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax year and is required to file Schedule M-3 for its 2010 tax year. N was depreciating certain fixed assets over an erroneous recovery period and, effective for its 2010 tax year, N receives IRS consent to change its method of accounting for the depreciable fixed assets and begins using the proper recovery period. The change in method of accounting results in a positive section 481(a) adjustment of \$100,000 that is required to be spread over four tax years, beginning with the 2010 tax year. In its financial statements, N treats the section 481(a) adjustment as a temporary difference. N must report on Part II, line 19, \$25,000 in columns (b) and (d) for its 2010 tax year and each of the subsequent three tax years (unless N is otherwise required to recognize the remainder of the 481(a) adjustment earlier). N must not report the section 481(a) adjustment on Part III, line 31.

Line 20. Unearned/Deferred Revenue

Report on line 20, column (a), amounts of revenues included in Part I, line 11, that were deferred from a prior financial accounting year. Report on line 20, column (d), amounts of revenues recognizable for U.S. federal income tax purposes in the current tax year that are recognized for financial accounting purposes in a different year. Also report on line 20, column (d), any amount of revenues reported on line 20, column (a), that are recognizable for U.S. income tax purposes in the current tax year. Use columns (b) and (c) of line 20, as applicable, to report the differences between column (a) and (d).

Line 20 must not be used to report income recognized from long-term contracts. Instead, use line 21.

Line 21. Income Recognition From Long-Term Contracts

Report on line 21 the amount of net income or loss for financial statement purposes (or books and records, if applicable) or U.S. federal income tax purposes for any contract accounted for under a long-term contract method of accounting.

Line 22. Original Issue Discount and Other Imputed Interest

Report on line 22 any amounts of original issue discount (OID) and imputed interest. The term "original issue discount and other imputed interest" includes, but is not limited to:

1. The difference between issue price and the stated redemption price at maturity of a debt instrument, which may be wholly or partially realized on the disposition of a debt instrument under section 1273;
2. Amounts that are imputed interest on a deferred sales contract under section 483;
3. Amounts treated as interest or OID under the stripped bond rules under section 1286; and
4. Amounts treated as OID under the below-market interest rate rules under section 7872.

Line 23a. Income Statement Gain/Loss on Sale, Exchange, Abandonment, Worthlessness, or Other Disposition of Assets Other Than Inventory and Pass-Through Entities

Report on line 23a, column (a), all gains and losses on the disposition of assets except for (a) gains and losses on the disposition of inventory, and (b) gains and losses allocated to the corporation from a pass-through entity (e.g., on Schedule K-1) that are included in the net income (loss) per income statement of includible corporations reported on Part I, line 11. Reverse the amount reported in column (a) in column (b) or (c), as applicable. The corresponding gains and losses for U.S. income tax purposes are reported on Part II, lines 23b through 23g, as applicable.

Line 23b. Gross Capital Gains From Schedule D, Excluding Amounts From Pass-Through Entities

Report on line 23b, gross capital gains reported on Schedule D, excluding capital gains from pass-through entities, which must be reported on Part II, lines 9, 10, or 11, as applicable.

Line 23c. Gross Capital Losses From Schedule D, Excluding Amounts From Pass-Through Entities, Abandonment Losses, and Worthless Stock Losses

Report on line 23c, gross capital losses reported on Schedule D, excluding capital losses from (a) pass-through entities, which must be reported on Part II, lines 9, 10, or 11, as applicable; (b) abandonment losses, which must be reported on Part II, line 23e; and (c) worthless stock losses, which must be reported on Part II, line 23f. Do not report on line 23c capital losses carried over from a prior tax year and utilized in the current tax year. See the instructions for Part II, line 24, regarding the reporting requirements for capital loss carryovers utilized in the current tax year.

Line 23d. Net Gain/Loss Reported on Form 4797, Line 17, Excluding Amounts From Pass-Through Entities, Abandonment Losses, and Worthless Stock Losses

Report on line 23d the net gain or loss reported on line 17 of Form 4797, Sales of Business Property, excluding amounts from (a) pass-through entities, which must be reported on Part II, lines 9, 10, or 11, as applicable; (b) abandonment losses, which must be reported on Part II, line 23e; and (c) worthless stock losses, which must be reported on Part II, line 23f.

Line 23e. Abandonment Losses

Report on line 23e any abandonment losses, regardless of whether the loss is characterized as an ordinary loss or a capital loss.

Line 23f. Worthless Stock Losses

Report on line 23f any worthless stock loss, regardless of whether the loss is characterized as an ordinary loss or a capital loss. Attach a schedule that separately states and adequately discloses each transaction that gives rise to a worthless stock loss and the amount of each loss.

Line 23g. Other Gain/Loss on Disposition of Assets Other Than Inventory

Report on line 23g any gains or losses from the sale or exchange of property other than inventory and that are not reported on lines 23b through 23f.

Line 24. Capital Loss Limitation and Carryforward Used

Report as a positive amount on line 24, columns (b) or (c), as applicable, and (d), the excess of the net capital losses over the net capital gains reported on Schedule D, Capital Gains and Losses, by the corporation. For a U.S. consolidated tax group, the Schedule M-3 adjustment for the amount of the consolidated net capital loss that is disallowed should not be made on the separate consolidating Schedules M-3 of the

includible corporations, but on the separate Schedule M-3 for consolidation eliminations as described in *Completion of Schedule M-3 and Certain Allocations, Limitations and Carryovers*, earlier.

If the corporation utilizes a capital loss carryforward on Schedule D in the current tax year, report the carryforward utilized as a negative amount on Part II, line 24, columns (b) or (c), as applicable, and column (d). For a U.S. consolidated tax group, the Schedule M-3 adjustment for the amount of the consolidated capital loss carryforward should not be made on the separate consolidating Schedules M-3 of the includible corporations, but on the separate Schedule M-3 for consolidation eliminations (or on Form 8916 in the case of a mixed group) as described under *Completion of Schedule M-3 and Certain Allocations, Limitations, and Carryovers*, earlier.

Line 25. Other Income (Loss) Items With Differences

Separately state and adequately disclose on Part II, line 25, all items of income (loss) with differences that are not otherwise listed on Part II, lines 1 through 24. Attach a schedule that itemizes the type of income (loss) and the amount of each item and provides a description that states the income (loss) name for book purposes for the amount recorded in column (a) and describes the adjustment being recorded in column (b) or (c). The entire description completes the tax description for the amount included in column (d) for each item separately stated on this line.

The attached schedule should have five columns. The first column has the description for the next four columns. The second column is column (a) income (loss) per income statement, third column is column (b) temporary difference, the fourth column is column (c) permanent difference, and the fifth column is column (d) income (loss) per tax return. Every item listed on the attached schedule for line 25 must always have columns (a) + (b) + (c) = (d). Each item with amounts in columns (a), (b), (c), and (d) will be totaled and included as one line on line 25 of the face of the schedule.

If any “comprehensive income” as defined by Statement of Financial Accounting Standards (SFAS) No. 130 is reported on this line, describe the item(s) in detail. Examples of sufficiently detailed descriptions include “Foreign currency translation adjustments – comprehensive income” and “gains and losses on available-for-sale securities – comprehensive income.”

Whether an item of income (loss) is reported on line 25, or is reported on Part II, line 28, is determined separately by each member of the U.S. consolidated tax group and not at the U.S. consolidated tax group level. For example, U.S. Corporation P has two subsidiaries, Corporation A and B, that are included in P’s consolidated financial statements and in P’s consolidated U.S. income tax return. For financial statement purposes, P, A, and B recognize revenue from the sale of inventory upon delivery to the customer. For U.S. income tax purposes, P and A recognize such revenue consistent with the method used for financial statement purposes, whereas B recognizes such revenue based upon customer acceptance. P and A must report this revenue in column (a) and (d) on Part II, line 28. B must report the following on Part II, line 25: in column (a), B’s revenue recognized in the financial statements based upon delivery to the customer; in column (d), B’s revenue recognized for U.S. income tax purposes based upon customer acceptance; and in column (b) or (c), as applicable, the difference between B’s revenue recognized in its financial statements and in its U.S. taxable income.

Line 27. Total Expense/ Deduction Items

Report on Part II, line 27, columns (a) through (d), as applicable, the negative of the amounts reported on Part III, line 36, columns (a) through (d). Report positive amounts as negative and negative amounts as positive. For example, if Part III, line 36, column (a), reflects an amount of \$1 million then report on Part II, line 27, column (a), (\$1 million). Similarly, if Part III, line 36, column (b), reflects an amount of (\$50,000), then report on Part II, line 27, column (b), \$50,000.

Line 28. Other Items With No Differences

If there is no difference between the financial accounting amount and the taxable amount of an entire item of income, gain, loss, expense, or deduction and the item is not described or included in Part II, lines 1 through 25, or Part III, lines 1 through 37, report the entire amount of the item in columns (a) and (d) of line 28. If a portion of an item of income, loss, expense, or deduction has a difference and a portion of the item does not have a difference, do not report any portion of the item on line 28. Instead, report the entire amount of the item (i.e., both the portion with a difference and the portion without a difference) on the applicable line of Part II, lines 1 through 25, or Part III, lines 1 through 37. See Example 10, earlier.

Line 29a. 1120 subgroup reconciliation totals

For filers other than a mixed group, combine lines 26 through 28 and skip lines 29b and 29c. On the sub-consolidated Schedule M-3 for a mixed group, combine lines 26 through 28 and skip lines 29b and 29c. For the consolidated Schedule M-3 of a mixed group, complete only lines 29a through 29c and line 30 of Part II. No Part III is required to be completed for the consolidated Schedule M-3 of a mixed group.

Line 29b. PC insurance subgroup reconciliation totals

Line 29b is only used by mixed groups.

Line 29c. Life insurance subgroup reconciliation totals

Line 29c is only used by mixed groups.

Line 30. Reconciliation Totals. Combine lines 29a through 29c

If a corporation that is not a mixed group chooses not to complete columns (a) and (d) of Parts II and III in the first tax year the corporation is required to file Schedule M-3 (or for any year in which the corporation voluntarily files Schedule M-3), Part II, line 30, is reconciled by the corporation (or, in the case of a U.S. consolidated tax group, on the group's consolidated Schedule M-3) in the following manner:

1. Report the amount from Part I, line 11, on Part II, line 30, column (a);
2. Leave blank Part II, lines 1 through 29, columns (a) and (d);
3. Leave blank Part III, columns (a) and (d); and
4. Report on Part II, line 30, column (d), the sum of Part II, line 30, columns (a), (b), and (c).

VI. Part III. Reconciliation of Net Income (Loss) Per Income Statement of Includible Corporations With Taxable Income Per Return – Expense/Deduction Items

Note. Expense amounts that reduce financial accounting income must be reported on Part III, column (a), as positive amounts. Deduction amounts that reduce taxable income must be reported on Part III, column (d), as positive amounts. Amounts reported on Part II, line 27, must be the negative of the amounts reported on Part III, line 36.

Lines 1 Through 6. Income Tax Expense

If the corporation does not distinguish between current and deferred income tax expense in its financial statements (or its books and records, if applicable), report income tax expense as current income tax expense using lines 1, 3, and 5, as applicable.

A U.S. consolidated tax group must complete lines 1 through 6 in accordance with the allocation of tax expense among the members of the U.S. consolidated tax group in the financial statements (or its books and records, if applicable). If the current and deferred U.S., state, and foreign income tax expense for the U.S. consolidated tax group (income tax expense) is allocated among the members of the U.S. consolidated tax group in the group's financial statements (or its books and records, if applicable), then each member must report its allocated income tax expense on Part III, lines 1 through 6, of that member's separate Schedule M-3. However, if the income tax expense is not shared or allocated among members of the U.S. consolidated tax group but is retained in the parent corporation's financial statements (or books and records, if applicable), then amounts are reported only on Part III, lines 1 through 6, of the parent's separate Schedule M-3.

Line 7. Foreign Withholding Taxes

Report on line 7, column (a), the amount of foreign withholding taxes included in financial accounting net income on Part I, line 11. If the corporation is deducting foreign tax, use column (b) or (c), as applicable, to correct for any difference between foreign withholding tax included in financial accounting net income and the amount of foreign withholding taxes being deducted in the return. If the corporation is crediting foreign withholding taxes against the U.S. income tax liability, use column (b) or (c), as applicable, to negate the amount reported in column (a).

Line 8. Interest Expense

Report on Part III, line 8, column (a), the total amount of interest expense included on Part I, line 11, and report on Part III, line 8, column (d), the total amount of interest deduction included on Form 1120, page 1, line 28, that is not required to be reported elsewhere on Schedule M-3. In columns (b) or (c), as applicable, include any adjustments for any amounts treated for U.S. federal income tax purposes as interest deduction that are treated as some other form of expense in the financial statements, or vice versa. For example, adjustments to interest expense/deduction resulting from adjustments made in accordance with the instructions for Part III, line 34, should be made in columns (b) and (c), as applicable, on this line 8.

Complete Part III of Form 8916-A. Enter the amounts from line 5, columns (a) through (d) of Form 8916-A, on Schedule M-3, Part III, line 8, columns (a) through (d), as applicable. Attach Form 8916-A.

Do not report on Form 8916-A and this line 8 amounts reported in accordance with the instructions for Part II, lines 9, 10, 11, and 12.

Line 9. Stock Option Expense

Report on line 9, column (a), amounts expensed on Part I, line 11, net income per the income statement, that are attributable to all stock options. Report on line 9, column (d), deduction amounts attributable to all stock options.

Line 10. Other Equity-Based Compensation

Report on line 10 any amounts for equity-based compensation or consideration that are reflected as expense in the financial statements (column (a)) or deducted in the U.S. federal income tax return (column (d)) other than amounts reportable elsewhere on Schedule M-3, Parts II and III (e.g., on Part III, line 9, for stock options expense). Examples of amounts reportable on line 10 include payments attributable to employee stock purchase plans (ESPPs), phantom stock options, phantom stock units, stock warrants, stock appreciation rights, and restricted stock, regardless of whether such payments are made to employees or nonemployees, or as payment for property or compensation for services.

Line 11. Meals and Entertainment

Report on line 11, column (a), any amounts paid or accrued by the corporation during the tax year for meals, beverages, and entertainment that are accounted for in financial accounting income, regardless of the classification, nomenclature, or terminology used for such amounts, and regardless of how or where such amounts are classified in the corporation's financial income statement or the income and expense accounts maintained in the corporation's books and records. Report only amounts not otherwise reportable elsewhere on Schedule M-3, Parts II and III (e.g., Part II, line 17).

Line 12. Fines and Penalties

Report on line 12 any fines or similar penalties paid to a government or other authority for the violation of any law for which fines or penalties are assessed. All fines and penalties expensed in financial accounting income (paid or accrued) must be included on this line 12, column (a), regardless of the government or other authority that imposed the fines or penalties, regardless of whether the fines and penalties are civil or criminal, regardless of the classification, nomenclature, or terminology used for the fines or penalties by the imposing authority in its actions or documents, and regardless of how or where the fines or penalties are classified in the corporation's financial income statement or the income and expense accounts maintained in the corporation's books and records. Also report on line 12, column (a) the reversal of any overaccrual of any amount described in this paragraph. See section 162(f) for additional guidance.

Report on line 12, column (d), any such amounts as are described in the preceding paragraph that are includible in taxable income, regardless of the financial accounting period in which such amounts were or are included in financial accounting net income. Complete columns (b) and (c) as appropriate.

Do not report on this Part III, line 12 amounts required to be reported in accordance with instructions for Part III, line 13.

Do not report on this Part III, line 12 amounts recovered from insurers or any other indemnitors for any fines and penalties described above.

Line 13. Judgments, Damages, Awards, and Similar Costs

Report on line 13, column (a), the amount of any estimated or actual judgments, damages, awards, settlements, and similar costs, however named or classified, included in financial accounting income, regardless of whether the amount deducted was attributable to an estimate of future anticipated payments or actual payments. Also report on line 13, column (a) the reversal of any overaccrual of any amount previously described in this paragraph.

Report on line 13, column (d), any such amounts as are described in the preceding paragraph that are includible in taxable income, regardless of the financial accounting period in which such amounts were or are included in financial accounting net income. Complete columns (b) and (c) as appropriate.

Do not report on this Part III, line 13, amounts required to be reported in accordance with instructions for Part III, line 12.

Do not report on this Part III, line 13, amounts recovered from insurers or any other indemnitors for any judgments, damages, awards, or similar costs described above.

Line 14. Parachute Payments

Report on line 14, column (a), the total expense included in financial accounting net income on Part I, line 11, that is subject to section 280G. Report in column (b) or (c), as applicable, the amount of nondeductible parachute payments pursuant to section 280G, and report in column (d) the deductible amount of compensation after any excess parachute payment limitations under section 280G. If a payment is subject to limitation under both sections 162(m) and 280G, report the total payment on this line 14.

Line 15. Compensation With Section 162(m) Limitation

Report on line 15, column (a), the total amount of non-performance-based current compensation expense for the corporate officers to whom section 162(m) applies. Report the nondeductible amount of current compensation in excess of \$1 million (\$500,000 if the corporation receives or has received financial assistance under the Treasury Troubled Asset Relief Program (TARP)) in column (b) or (c), as applicable, and the deductible compensation in column (d). If a payment is subject to limitation under both sections 162(m) and 280G, report the total payment on Part III, line 14. See Regulations section 1.162-27(g) for the interaction between sections 162(m) and 280G.

Line 16. Pension and Profit-Sharing

Report on line 16 any amounts attributable to the corporation's pension plans, profit-sharing plans, and any other retirement plans.

Line 17. Other Post-Retirement Benefits

Report on line 17 any amounts attributable to other post-retirement benefits not otherwise includible on Part III, line 16 (for example, retiree health and life insurance coverage, dental coverage, etc).

Line 18. Deferred Compensation

Report on line 18, column (a), any compensation expense included in the net income (loss) amount reported in Part I, line 11 that is not deductible for U.S. income tax purposes in the current tax year and that was not reported elsewhere on Schedule M-3, column (a). Report on line 18, column (d), any compensation deductible in the current tax year that was not included in the net income (loss) amount reported in Part I, line 11 for the current tax year and that is not reportable elsewhere on Schedule M-3. For example, report originations and reversals of deferred compensation subject to section 409A on line 18.

Line 20. Charitable Contribution of Intangible Property

Report on line 20 any charitable contribution of intangible property, for example, contributions of:

- Intellectual property, patents (including any amounts of additional contributions allowable by virtue of income earned by donees subsequent to the year of donation), copyrights, trademarks;
- Securities (including stocks and their derivatives, stock options, and bonds);
- Conservation easements (including scenic easements or air rights);
- Railroad rights of way;
- Mineral rights; and
- Other intangible property.

Line 21. Charitable Contribution Limitation/Carryforward

Report as a negative amount on line 21, columns (b), (c), and (d) as applicable, the excess of charitable contributions made during the tax year over the amount of the charitable contribution limitation amount.

If the corporation utilizes a contribution carryforward in the current tax year, report the carryforward utilized as a positive amount on columns (b), (c), and (d), as applicable.

When a consolidated income tax return is being filed, Schedule M-3 adjustments for the amount of charitable contributions in excess of the limitation, or for charitable contribution carryforward utilized, should not be made on the separate consolidating Schedules M-3 of the includible corporations, but on the separate consolidating Schedule M-3 for consolidation eliminations as described in *Completion of Schedule M-3 and Certain Allocations, Limitations, and Carryovers*, earlier.

Line 22. Domestic Production Activities Deduction

Report on Part III, line 22, column (d) the corporation's domestic production activities deduction under section 199 that is reported on Form 1120, page 1, line 25. Complete columns (b) and (c) as appropriate. Do not report any portion of the corporation's domestic production activities deduction on any other line of Schedule M-3.

Line 23. Current Year Acquisition or Reorganization Investment Banking Fees

Report on line 23 any investment banking fees paid or incurred in connection with a taxable or tax-free acquisition of property (e.g., stock or assets) or a tax-free reorganization. Report on this line any investment banking fees incurred at any stage of the acquisition or reorganization process including, for example, fees paid or incurred to evaluate whether to investigate an acquisition, fees to conduct an actual investigation, and fees to consummate the acquisition. Also include on this line 23 investment banking fees incurred in connection with the liquidation of a subsidiary, a spin-off of a subsidiary, or an initial public stock offering.

Line 24. Current Year Acquisition or Reorganization Legal and Accounting Fees

Report on line 24 any legal and accounting fees paid or incurred in connection with a taxable or tax-free acquisition of property (e.g., stock or assets) or tax-free reorganization. Report on this line any legal and accounting fees incurred at any stage of the acquisition or reorganization process including, for example, fees paid or incurred to evaluate whether to investigate an acquisition, fees to conduct an actual investigation, and fees to consummate the acquisition. Also include on this line legal and accounting fees incurred in connection with the liquidation of a subsidiary, a spin-off of a subsidiary, or an initial public stock offering.

Line 25. Current Year Acquisition/Reorganization Other Costs

Report on line 25 any other fees paid or incurred in connection with a taxable or tax-free acquisition of property (e.g., stock or assets) or a tax-free reorganization not otherwise reportable on Schedule M-3 (e.g., Part III, line 23 or 24). Report on this line any fees paid or incurred at any stage of the acquisition or reorganization process including, for example, fees paid or incurred to evaluate whether to investigate an acquisition, fees to conduct an actual investigation, and fees to consummate the acquisition. Also include on this line other acquisition/ reorganization costs incurred in connection with the liquidation of a subsidiary, a spin-off of a subsidiary, or an initial public stock offering.

Line 26. Amortization/ Impairment of Goodwill

Report on line 26 amortization of goodwill or amounts attributable to the impairment of goodwill.

Line 27. Amortization of Acquisition, Reorganization, and Start-Up Costs

Report on line 27 amortization of acquisition, reorganization, and start-up costs. For purposes of column (b), (c), and (d), include amounts amortizable under section 167, 195, or 248.

Line 28. Other Amortization or Impairment Write-Offs

Report on line 28 any amortization or impairment write-offs not otherwise includible on Schedule M-3.

Line 29. Section 198 Environmental Remediation Costs

Report on line 29, column (a), any amounts attributable to environmental remediation costs included on Part I, line 11. Report in columns (b), (c), and (d), as applicable, any deductible amounts attributable to environmental remediation costs described in section 198 that are paid or incurred during the current tax year.

Line 31. Depreciation

Report on line 31 any depreciation expense that is not required to be reported elsewhere on Schedule M-3 (e.g., on Part II, lines, 9, 10, 11, or 17).

Line 32. Bad Debt Expense

Report on line 32, column (a), any amounts attributable to an allowance for uncollectible accounts receivable or actual write-offs of accounts receivable included in net income per the income statement. Report in column (d) the amount of bad debt expense deductible for federal income tax purposes in accordance with section 166.

Line 33. Corporate Owned Life Insurance Premiums

Report on line 33 all amounts of insurance premiums attributable to any life insurance policy if the corporation is directly or indirectly a beneficiary under the policy or if the policy has a cash value. Report in column (d) the amount of the premiums that are deductible for federal income tax purposes.

Line 34. Purchase Versus Lease (for Purchasers and/or Lessees)

Note. Also see the instructions at Part II, line 18, earlier, for sellers and/or lessors.

Asset transfer transactions with periodic payments characterized for financial accounting purposes as either a purchase or a lease may, under some circumstances, be characterized as the opposite for tax purposes.

If a transaction is treated as a lease, the purchaser/lessee reports the periodic payments as gross rental expense. If the transaction is treated as a purchase, the purchaser/lessee reports the periodic payments as payments of principal and interest and also reports depreciation expense or deduction with respect to the purchased asset.

Report in column (a), gross rent expense for a transaction treated as a lease for income statement purposes but as a sale for U.S. income tax purposes. Report in column (d), gross rental deductions for a transaction treated as a lease for U.S. income tax purposes but as a purchase for income statement purposes. Report interest expense for such transactions on Part III, line 8, in column (a) or (d), as applicable. Report depreciation expense or deductions for such transactions on Part III, line 31, in column (a) or (d), as applicable. Use columns (b) and (c) of Part III, lines 8, 31, and 34, as applicable, to report the differences between column (a) and (d) for such recharacterized transactions.

Example 20.

U.S. corporation X acquired property in a transaction that, for financial accounting purposes, X treats as a lease. X is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax year and is required to file Schedule M-3 for its 2010 tax year. For U.S. income tax purposes, because of its terms, the transaction is treated for U.S. income tax purposes as a purchase and X must treat the periodic payments it makes partially as payment of principal and partially as payment of interest. In its financial statements, X treats the difference between the financial accounting and U.S. income tax treatment of this transaction as a temporary difference. During 2010, X reports in its financial statements \$1,000 of gross rental expense that, for U.S. income tax purposes, is recharacterized as a \$700 payment of principal and a \$300 payment of interest, accompanied by a depreciation deduction of \$1,200 (based on other facts). On its 2010 Schedule M-3, X must report the following on Part III, line 34: column (a) \$1,000, its financial accounting gross rental expense; column (b), (\$1,000); and column (d), zero. On Part III, line 8, X reports zero in column (a) and \$300 in columns (b) and (d) for the interest deduction. On Part III, line 31, X reports zero in column (a) and \$1,200 in columns (b) and (d) for the depreciation deduction.

Line 35. Research and Development Costs

Report in column (a) the amount of expenses included in net income reported on Part I, line 11, that are related to research and development expense. Report in column (d) the amount of deductions included in Form 1120, page 1, line 27 that are recognized and reported as Section 174 research and experimental expenditures consistent with the corporation's adopted method of accounting for such expenditures. In column (c), as applicable, include any adjustments for any amounts treated for U.S. income tax purposes as research or experimental expenditures that are treated as some other form of expense for financial accounting purposes, or vice versa. Report any difference in timing recognition in column (b). For example, if the taxpayer's financial accounting method does not specify otherwise, column (b) adjustments include adjustments for timing differences between financial and tax accounting for: (1) deferral and amortization of research expenditures, (2) a section 59(e) election, (3) reduction of section 174 expenditures under section 280C or section 482, (4) costs attributable to obtaining a patent, (5) research in social sciences, and (6) cost elements for property of a character subject to depreciation.

Section 174 provides two methods for the treatment of research and experimental expenditures paid or incurred by a taxpayer in connection with the taxpayer's trade or business. These expenditures may be treated as expenses not chargeable to a capital account and deducted in the year in which they are paid or incurred, or they may be deferred and amortized. Since the method for treatment of research and experimental expenditures is adopted at the subsidiary level, the expense/deduction item is determined separately by each member of a U.S. consolidated tax group and not at the U.S. consolidated tax group level. For example, U.S. Corporation P has two subsidiaries, A and B, which are included in P's consolidated financial statements and in P's consolidated U.S. income tax return. For financial purposes, P, A, and B recognize research and development cost as an expense when accrued. For U.S. income tax purposes, P and A recognize such costs consistent with the method used for financial purposes, whereas B capitalizes and amortizes such costs. P and A must report these

expenses in columns (a) and (d). B must report its expense recognized in the financial statements when accrued in column (a); in column (d), B's research and development expenditures recognized for U.S. income tax purposes; and in columns (b) and (c), as applicable, the difference between B's research and development costs in its financial statements and its research and experimental expenditures for U.S. taxable income purposes.

Attach a schedule supporting the amounts reported on this line in columns (a), (b), (c), and (d). The schedule must separately state and adequately disclose the transactions summarized by this line.

The attached schedule should have five columns. The first column has the description for the next four columns. The second column is column (a) expense per income statement, the third column is column (b) temporary difference, the fourth column is column (c) permanent difference, and the fifth column is column (d) deduction per tax return. Every item listed on the attached schedule must always have columns (a) + (b) + (c) = (d). On the attached schedule, the column total amounts for columns (a), (b), (c), and (d) must equal the column amounts reported on this line.

The attached schedule may use a short description keyed to an expanded description in an additional attachment. The short description of the transaction should be phrased in such a way as to clearly identify: (1) the account name under which the amount recorded in column (a) was recorded in the financial statements or books of the taxpayer, and (2) what adjustment is being recorded in either column (b) or column (c) for that transaction. The entire description is considered to be the tax description for the amount recorded in column (d) for that item.

Example 21.

Corporation X is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax return and is required to file Schedule M-3 for its 2010 tax year. During 2010, X incurred \$100,000 of research and development costs that X recognized as an expense in its financial statements. Also, X incurred \$20,000 in attorney fees in obtaining a patent application that X capitalized and amortized in its financial statements. X recognized a \$2,000 amortization deduction. In compliance with its adopted method of accounting under section 174, X deducts research and experimental expenditures for U.S. income tax purposes. Accordingly, X must report \$100,000 in column (a), \$20,000 in column (b), and \$120,000 in column (d). X must also report \$2,000 in column (a), (\$2,000) in column (b), and \$0 in column (d) on Part III, line 30, Other amortization or impairment write-offs.

Example 22.

Assume the same facts as Example 20 except Corporation X makes an annual election under section 59(e) to deduct \$80,000 of its \$120,000 of research and experimental expenditures over a 10-year period. Accordingly, X must report \$100,000 in column (a), a temporary difference of (\$52,000) (\$20,000 less (\$80,000/10 years X 9 years)) in column (b), and \$48,000 in column (d). X must also report \$2000 in column (a), (\$2000) in column (b), and \$0 in column (d) on Part III, line 30, Other amortization or impairment write-offs.

Example 23.

Assume the same facts as Example 21 except Corporation X elected to capitalize and amortize its research and expenditures over 60 months with respect to all its research programs for U.S. tax purposes. X first realized benefits from such expenditures on August 1. Accordingly, X must report \$100,000 in column (a), a temporary difference of (\$90,000) (\$20,000 less (\$120,000/60 months X 55 months)) in column (b), and \$10,000 in column (d).

Example 24.

Corporation X is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax return and is required to file Schedule M-3 for its 2010 tax year. X adopted the current expense method to research and experimental expenditures for U.S. income tax purposes. During 2010, X incurred \$50,000 of research and development costs that X recognized as an expense in its financial statements. Also, X undertook to develop a new machine for its business. X expended \$30,000 on the project of which \$10,000 represents actual costs of material, labor, and component cost to construct the machine, and \$20,000 represents research costs not attributable to the machine itself. X capitalized all costs of \$30,000 related to the machine and recognized \$6,000 of depreciation expense in its financial statements. X's depreciation expense on the \$10,000 of costs related to the machine itself was \$2,000 for U.S. income tax purposes. Accordingly, X must report \$50,000 in column (a), \$20,000 (research costs which are not attributable to the machine itself) in column (b), and \$70,000 in column (d). X must also report \$6,000 in column (a), (\$4,000) in column (b), and \$2,000 in column (d) on Part III, line 32, Depreciation.

Example 25.

Corporation X is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax return and is required to file Schedule M-3 for its 2010 tax year. During 2010, X incurred \$10,000 of research and development costs related to social sciences that it recognized as an expense in its financial statements. X adopted the current expense method to research and experimental expenditures for U.S. income tax purposes. Because such costs are not allowable costs under section 174, X must report \$10,000 in column (a), permanent difference (\$10,000) in column (c), and \$0 in column (d). If such costs are otherwise deductible for U.S. income tax purposes, X must report this item of expense on Part III, line 40, Other expense/deduction items with differences.

Example 26.

Corporation X is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax return and is required to file Schedule M-3 for its 2010 tax year. During 2010, X paid \$75,000 to acquire or in-license intangible assets under a collaborative arrangement with another company that X recognized as a research and development expense in its financial statements. X adopted the current expense method to research and experimental expenditures for U.S. income tax purposes. Because payments made to acquire rights to a product or technology are excluded costs from the definition of research and experimental expenditures, X must report \$75,000 in column (a), (\$75,000) in column (c), and \$0 in column (d). X must report any amortization otherwise allowable related to the payments on Part III, line 30, Other amortization or impairment write-offs.

Example 27.

Corporation X is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax return and is required to file Schedule M-3 for its 2010 tax year. X adopted the current expense method for research and experimental expenditures for U.S. income tax purposes. During 2010, X incurred \$100,000 of research and development costs that X recognized as an expense for both financial accounting and U.S. income tax purposes. A portion of the expenses were credit eligible expenses, and X claimed a research credit of \$1,000. X did not make the reduced credit election under section 280C. Accordingly, since X's financial accounting method does not specify otherwise, X must report \$100,000 in column (a), (\$1,000) (reduction of research and experimental expenditures to the extent of the credit amount) in column (b), and \$99,000 in column (d).

Line 36. Section 118 Exclusion

Report on line 36 any inducements received in the current year and treated as contributions to the capital of a corporation by a non-shareholder. Report in column (a) any income amount as a negative number and any expense amount as a positive number.

Corporations must identify on an accompanying schedule referencing line 36 the fair market value of land or other property (including cash) provided to the corporation by any non-shareholder, including a governmental unit or civic group, as an inducement, or for any other purpose. Include inducements for the corporation to locate its business in a particular state, municipality, community, or locality for the purpose of enabling the corporation to expand its existing operating facilities, including corporate headquarters, distribution center(s), or factory(ies) ("inducements").

On the accompanying schedule also identify any inducements that include refundable or transferable tax credits, including transferable credits that were sold.

The schedule must separately state, adequately disclose, and identify all of the dollar amounts summarized by this line. An accompanying schedule is required even if there are no dollar amounts reported on line 36.

Line 37. Other Expense/ Deduction Items With Differences

Separately state and adequately disclose on Part III, line 37, all items of expense/deduction that are not otherwise listed on Part III, lines 1 through 36.

Attach a schedule that describes and itemizes the type of expense/deduction and the amount of each item, and provides a description that states the expense/deduction name for book purposes for the amount recorded in column (a) and describes the adjustment being recorded in column (b) or (c). The entire description completes the tax description for the amount included in column (d) for each item separately stated on this line.

The schedule of details attached to the Schedule M-3 for line 37 must separately state and adequately disclose the nature and amount of the expense related to each reserve and/or contingent liability. The appropriate level of disclosure depends upon each taxpayer's operational activity and the nature of its accounting records. For example, if a corporation's net income amount reported in the income statement includes anticipated expenses for a discontinued operation as a single amount, and its general ledger or other books, records, and workpapers provide details for the anticipated expenses under more explanatory and defined categories such as employee termination costs, lease cancellation costs, loss on sale of equipment, etc., a supporting schedule that lists those categories of expenses and their details will satisfy the requirement to separately state and adequately disclose. In order to separately state and adequately disclose the employee termination costs, it is not required that an anticipated termination cost amount be listed for each employee, or that each asset (or category of asset) be listed along with the anticipated loss on disposition.

The attached schedule should have five columns. The first column has the description for the next four columns. The second column is column (a) expense per income statement, the third column is column (b) temporary difference, the fourth column is column (c) permanent difference, and the fifth column is column (d) deduction per tax return. Every item listed on the attached schedule for line 37 must always have columns (a) + (b) + (c) = (d). Each item with amounts in columns (a), (b), (c), and (d) will be totaled and included as one line on line 37 on the face of the schedule.

Comprehensive income. If any "comprehensive income" as defined by SFAS No. 130 is reported on this line, describe the item(s) in detail as, for example, "Foreign currency translation adjustments – comprehensive income" and "Gains and losses on available-for-sale securities – comprehensive income."

Reserves and contingent liabilities. Report on line 37 amounts related to the change in each reserve or contingent liability that is not required to be reported elsewhere on Schedule M-3. For example: (1) amounts relating to changes in reserves for litigation must be reported on Part III, line 13, Judgments, damages, awards, and similar costs; and (2) amounts relating to changes in reserves for uncollectible accounts receivable must be reported on Part III, line 32, Bad debt expense. See Examples 8 and 27.

Report on line 37 the amortization of various items of prepaid expense, such as prepaid subscriptions and license fees, prepaid insurance, etc.

Report on line 37, column (a), expenses included in net income reported on Part I, line 11, that are related to reserves and contingent liabilities. Report on line 37, column (d), amounts related to liabilities for reserves and contingent liabilities that are deductible in the current tax year for U.S. income tax purposes. Examples of reserves that are allowed for book purposes, but not for tax purposes, include warranty reserves, restructuring reserves, reserves for discontinued operations, and reserves for acquisitions and dispositions. Only report on line 37 items that are not required to be reported elsewhere on Schedule M-3, Parts II and III.

Example 28.

Corporation Q is a calendar year taxpayer that was required to file Schedule M-3 for its 2009 tax year and is required to file Schedule M-3 for its 2010 tax year. On July 1 of each year, Q has a fixed liability for its annual insurance premiums that provides a 12-month coverage period beginning July 1 through June 30. In addition, Q historically prepays 12 months of advertising expense on July 1. On July 1, 2010, Q prepays its insurance premium of \$500,000 and advertising expenses of \$800,000. For statutory accounting purposes, Q capitalizes and amortizes the prepaid insurance and advertising over 12 months. For U.S. income tax purposes, Q deducts the insurance premium when paid and amortizes the advertising over the 12-month period. In its annual statements, Q treats the differences attributable to the annual statement treatment and U.S. income tax treatment of the prepaid insurance and advertising as temporary differences.

Q also has a legal reserve where \$300,000 was expensed for financial accounting purposes and a (\$100,000) temporary difference was calculated to arrive at the income tax deduction of \$200,000. The schedule attached to Q's return for Part III, line 37 must be separately stated and adequately disclosed as follows:

Description	Column (a) Expense per Income Statement	Column (b) Temporary Difference	Column (c) Permanent Difference	Column (d) Deduction per Tax Return
Prepaid insurance premium expenses not capitalized	\$250,000	\$250,000	-0-	\$500,000
Legal expense reserve	\$300,000	(\$100,000)	-0-	\$200,000
Total Line 37	\$550,000	\$150,000	-0-	\$700,000

Line 38. Total Expense/ Deduction Items

Report on Part II, line 27, columns (a) through (d), as applicable, the negative of the amounts reported on Part III, line 38, column (a) through (d), as applicable. Report positive amounts as negative and negative amounts as positive. For example, if Part III, line 38, column (a), reflects an amount of \$1 million, then report on Part II, line 27, column (a), (\$1 million). Similarly, if Part III, line 38, column (b), reflects an amount of (\$50,000), then report on Part II, line 27, column (b), \$50,000.

**SCHEDULE M-3
(Form 1120)**

Department of the Treasury
Internal Revenue Service

**Net Income (Loss) Reconciliation for Corporations
With Total Assets of \$10 Million or More**

▶ Attach to Form 1120 or 1120-C.
▶ See separate instructions.

OMB No. 1545-0123

2010

Name of corporation (common parent, if consolidated return)	Employer identification number
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- Check applicable box(es): (1) Non-consolidated return (2) Consolidated return (Form 1120 only)
 (3) Mixed 1120/L/PC group (4) Dormant subsidiaries schedule attached

Part I Financial Information and Net Income (Loss) Reconciliation (see instructions)

1a Did the corporation file SEC Form 10-K for its income statement period ending with or within this tax year?
 Yes. Skip lines 1b and 1c and complete lines 2a through 11 with respect to that SEC Form 10-K.
 No. Go to line 1b. See instructions if multiple non-tax-basis income statements are prepared.

b Did the corporation prepare a certified audited non-tax-basis income statement for that period?
 Yes. Skip line 1c and complete lines 2a through 11 with respect to that income statement.
 No. Go to line 1c.

c Did the corporation prepare a non-tax-basis income statement for that period?
 Yes. Complete lines 2a through 11 with respect to that income statement.
 No. Skip lines 2a through 3c and enter the corporation's net income (loss) per its books and records on line 4a.

2a Enter the income statement period: Beginning MM/DD/YYYY Ending MM/DD/YYYY

b Has the corporation's income statement been restated for the income statement period on line 2a?
 Yes. (If "Yes," attach an explanation and the amount of each item restated.)
 No.

c Has the corporation's income statement been restated for any of the five income statement periods preceding the period on line 2a?
 Yes. (If "Yes," attach an explanation and the amount of each item restated.)
 No.

3a Is any of the corporation's voting common stock publicly traded?
 Yes.
 No. If "No," go to line 4a.

b Enter the symbol of the corporation's primary U.S. publicly traded voting common stock

c Enter the nine-digit CUSIP number of the corporation's primary publicly traded voting common stock

4a Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1 . . .	4a	
b Indicate accounting standard used for line 4a (see instructions): (1) <input type="checkbox"/> GAAP (2) <input type="checkbox"/> IFRS (3) <input type="checkbox"/> Statutory (4) <input type="checkbox"/> Tax-basis (5) <input type="checkbox"/> Other (specify) _____		
5a Net income from nonincludible foreign entities (attach schedule)	5a	{ <input style="width:100px;" type="text"/> }
b Net loss from nonincludible foreign entities (attach schedule and enter as a positive amount)	5b	<input style="width:100px;" type="text"/>
6a Net income from nonincludible U.S. entities (attach schedule)	6a	{ <input style="width:100px;" type="text"/> }
b Net loss from nonincludible U.S. entities (attach schedule and enter as a positive amount)	6b	<input style="width:100px;" type="text"/>
7a Net income (loss) of other includible foreign disregarded entities (attach schedule)	7a	<input style="width:100px;" type="text"/>
b Net income (loss) of other includible U.S. disregarded entities (attach schedule)	7b	<input style="width:100px;" type="text"/>
c Net income (loss) of other includible entities (attach schedule)	7c	<input style="width:100px;" type="text"/>
8 Adjustment to eliminations of transactions between includible entities and nonincludible entities (attach schedule)	8	<input style="width:100px;" type="text"/>
9 Adjustment to reconcile income statement period to tax year (attach schedule)	9	<input style="width:100px;" type="text"/>
10a Intercompany dividend adjustments to reconcile to line 11 (attach schedule)	10a	<input style="width:100px;" type="text"/>
b Other statutory accounting adjustments to reconcile to line 11 (attach schedule)	10b	<input style="width:100px;" type="text"/>
c Other adjustments to reconcile to amount on line 11 (attach schedule)	10c	<input style="width:100px;" type="text"/>
11 Net income (loss) per income statement of includible corporations. Combine lines 4 through 10	11	<input style="width:100px;" type="text"/>

Note. Part I, line 11, must equal the amount on Part II, line 30, column (a), and Schedule M-2, line 2.

12 Enter the total amount (not just the corporation's share) of the assets and liabilities of all entities included or removed on the following lines.

	Total Assets	Total Liabilities
a Included on Part I, line 4 ▶	<input style="width:100%;" type="text"/>	<input style="width:100%;" type="text"/>
b Removed on Part I, line 5 ▶	<input style="width:100%;" type="text"/>	<input style="width:100%;" type="text"/>
c Removed on Part I, line 6 ▶	<input style="width:100%;" type="text"/>	<input style="width:100%;" type="text"/>
d Included on Part I, line 7 ▶	<input style="width:100%;" type="text"/>	<input style="width:100%;" type="text"/>

Name of corporation (common parent, if consolidated return) Employer identification number

Check applicable box(es): (1) Consolidated group (2) Parent corp (3) Consolidated eliminations (4) Subsidiary corp (5) Mixed 1120/L/PC group
 Check if a sub-consolidated: (6) 1120 group (7) 1120 eliminations

Name of subsidiary (if consolidated return) Employer identification number

Part II Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return (see instructions)

Income (Loss) Items (Attach schedules for lines 1 through 11)	(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
1 Income (loss) from equity method foreign corporations				
2 Gross foreign dividends not previously taxed				
3 Subpart F, QEF, and similar income inclusions				
4 Section 78 gross-up				
5 Gross foreign distributions previously taxed				
6 Income (loss) from equity method U.S. corporations				
7 U.S. dividends not eliminated in tax consolidation				
8 Minority interest for includible corporations				
9 Income (loss) from U.S. partnerships				
10 Income (loss) from foreign partnerships				
11 Income (loss) from other pass-through entities				
12 Items relating to reportable transactions (attach details)				
13 Interest income (attach Form 8916-A)				
14 Total accrual to cash adjustment				
15 Hedging transactions				
16 Mark-to-market income (loss)				
17 Cost of goods sold (attach Form 8916-A)	()			()
18 Sale versus lease (for sellers and/or lessors)				
19 Section 481(a) adjustments				
20 Unearned/deferred revenue				
21 Income recognition from long-term contracts				
22 Original issue discount and other imputed interest				
23a Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and pass-through entities				
b Gross capital gains from Schedule D, excluding amounts from pass-through entities				
c Gross capital losses from Schedule D, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
d Net gain/loss reported on Form 4797, line 17, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
e Abandonment losses				
f Worthless stock losses (attach details)				
g Other gain/loss on disposition of assets other than inventory				
24 Capital loss limitation and carryforward used				
25 Other income (loss) items with differences (attach schedule)				
26 Total income (loss) items. Combine lines 1 through 25				
27 Total expense/deduction items (from Part III, line 38)				
28 Other items with no differences				
29a Mixed groups, see instructions. All others, combine lines 26 through 28				
b PC insurance subgroup reconciliation totals				
c Life insurance subgroup reconciliation totals				
30 Reconciliation totals. Combine lines 29a through 29c				

Note. Line 30, column (a), must equal the amount on Part I, line 11, and column (d) must equal Form 1120, page 1, line 28.

Name of corporation (common parent, if consolidated return)	Employer identification number
Check applicable box(es): (1) <input type="checkbox"/> Consolidated group (2) <input type="checkbox"/> Parent corp (3) <input type="checkbox"/> Consolidated eliminations (4) <input type="checkbox"/> Subsidiary corp (5) <input type="checkbox"/> Mixed 1120/L/PC group	
Check if a sub-consolidated: (6) <input type="checkbox"/> 1120 group (7) <input type="checkbox"/> 1120 eliminations	
Name of subsidiary (if consolidated return)	Employer identification number

Part III Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return—Expense/Deduction Items (see instructions)

Expense/Deduction Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1 U.S. current income tax expense				
2 U.S. deferred income tax expense				
3 State and local current income tax expense				
4 State and local deferred income tax expense				
5 Foreign current income tax expense (other than foreign withholding taxes)				
6 Foreign deferred income tax expense				
7 Foreign withholding taxes				
8 Interest expense (attach Form 8916-A)				
9 Stock option expense				
10 Other equity-based compensation				
11 Meals and entertainment				
12 Fines and penalties				
13 Judgments, damages, awards, and similar costs				
14 Parachute payments				
15 Compensation with section 162(m) limitation				
16 Pension and profit-sharing				
17 Other post-retirement benefits				
18 Deferred compensation				
19 Charitable contribution of cash and tangible property				
20 Charitable contribution of intangible property				
21 Charitable contribution limitation/carryforward				
22 Domestic production activities deduction				
23 Current year acquisition or reorganization investment banking fees				
24 Current year acquisition or reorganization legal and accounting fees				
25 Current year acquisition/reorganization other costs				
26 Amortization/impairment of goodwill				
27 Amortization of acquisition, reorganization, and start-up costs				
28 Other amortization or impairment write-offs				
29 Section 198 environmental remediation costs				
30 Depletion				
31 Depreciation				
32 Bad debt expense				
33 Corporate owned life insurance premiums				
34 Purchase versus lease (for purchasers and/or lessees)				
35 Research and development costs (attach schedule)				
36 Section 118 exclusion (attach schedule)				
37 Other expense/deduction items with differences (attach schedule)				
38 Total expense/deduction items. Combine lines 1 through 37. Enter here and on Part II, line 27, reporting positive amounts as negative and negative amounts as positive				

Form 4626 - Alternative Minimum Tax—Corporations

I. What's New

For tax years beginning in 2010, eligible small business credits can offset both regular tax and alternative minimum tax (AMT). Any unused credit can be carried back five years and can be used to offset regular tax and AMT in the carryback years. For more information, see the instructions for Form 3800.

II. General Instructions

PURPOSE OF FORM

Use Form 4626 to figure the alternative minimum tax (AMT) under section 55 for a corporation that is not exempt from the AMT.

Consolidated returns. For an affiliated group filing a consolidated return under the rules of section 1501, AMT must be figured on a consolidated basis.

WHO MUST FILE

Generally, file Form 4626 if either of the following apply.

- The corporation is not a “small corporation” exempt from AMT (as explained below).
- The corporation’s taxable income or (loss) before the net operating loss (NOL) deduction plus its adjustments and preferences total more than \$40,000 or, if smaller, its allowable exemption amount.
- The corporation claims any general business credit, any qualified electric vehicle passive activity credit from prior years, or the credit for prior year minimum tax.

Exemption for Small Corporations

A corporation is treated as a small corporation exempt from the AMT for its current tax year beginning in 2010 if:

1. The current year is the corporation’s first tax year in existence (regardless of its gross receipts for the year), or
2. Both of the following apply.
 - a. It was treated as a small corporation exempt from the AMT for all prior tax years beginning after 1997.
 - b. Its average annual gross receipts for the 3-tax-year period (or portion thereof during which the corporation was in existence) ending before its tax year beginning in 2010 did not exceed \$7.5 million (\$5 million if the corporation had only 1 prior tax year).

The following rules apply when figuring gross receipts under 2b above.

- Gross receipts must be figured using the corporation's tax accounting method and include total sales (net of returns and allowances), amounts received for services, and income from investments and other sources. See Temporary Regulations section 1.448-1T(f)(2)(iv) for more details.
- Gross receipts include those of any predecessor of the corporation, including non-corporate entities.
- For a short tax year, gross receipts must be annualized by multiplying them by 12 and dividing the result by the number of months in the tax year.
- The gross receipts of all persons treated as a single employer under section 52(a), 52(b), 414(m), or 414(o) must be aggregated.

Loss of small corporation status. If the corporation qualified as a small corporation exempt from the AMT for its previous tax year, but does not meet the gross receipts test for its tax year beginning in 2010, it loses its AMT exemption status. Special rules apply in figuring AMT for the tax year beginning in 2010 and all later years based on the "change date." The change date is the first day of the corporation's tax year beginning in 2010 (the first tax year for which the corporation ceased to be a small corporation). Where this applies, complete Form 4626 taking into account the following modifications.

- The adjustments for depreciation and amortization of pollution control facilities apply only to property placed in service on or after the change date.
- The adjustment for mining exploration and development costs applies only to amounts paid or incurred on or after the change date.
- The adjustment for long-term contracts applies only to contracts entered into on or after the change date.
- When figuring the amount to enter on line 6, for any loss year beginning before the change date, use the corporation's regular tax NOL for that year.
- Figure the limitation on line 4d only for prior tax years beginning on or after the change date.
- Enter zero on line 2c of the Adjusted Current Earnings (ACE) Worksheet. When completing line 5 of the ACE Worksheet, take into account only amounts from tax years beginning on or after the change date. Also, for line 8 of the ACE Worksheet, take into account only property placed in service on or after the change date.

Note. No additional modification in figuring AMT is required for exceptions related to any item acquired in a corporate acquisition under section 381 or to any substituted basis property, if any of the AMT adjustment modifications listed earlier applied to the item or property while it was held by the transferor.

Caution. *Once the corporation loses its small corporation status, it cannot qualify for any subsequent tax year.*

CREDIT FOR PRIOR YEAR MINIMUM TAX

A corporation may be able to take a minimum tax credit against the regular tax for AMT incurred in prior years. See Form 8827, Credit for Prior Year Minimum Tax – Corporations, for details.

RECORDKEEPING

Certain items of income, deductions, credits, etc., receive different tax treatment for the AMT than for the regular tax. Therefore, the corporation should keep adequate records to support items refigured for the AMT. Examples include:

- Tax forms used for regular tax purposes that are completed a second time to refigure items of income, deductions, etc., for the AMT;
- The computation of a carryback or carryforward to other tax years of certain deductions or credits (for example, net operating loss, capital loss, and foreign tax credit) if the AMT amount is different from the regular tax amount;
- The computation of a carryforward of a passive loss or tax shelter farm activity loss if the AMT amount is different from the regular tax amount; and
- A “running balance” of the excess of the corporation’s total increases in alternative minimum taxable income (AMTI) from prior year adjusted current earnings (ACE) adjustments over the total reductions in AMTI from prior year ACE adjustments.

SHORT PERIOD RETURN

If the corporation is filing for a period of less than 12 months, AMTI must be annualized and the tentative minimum tax prorated based on the number of months in the short period. Complete Form 4626 as follows.

1. Complete lines 1 through 6 in the normal manner. Subtract line 6 from line 5 to figure AMTI for the short period, but do not enter it on line 7.
2. Multiply AMTI for the short period by 12. Divide the result by the number of months in the short period. Enter this result on line 7 and write “Sec. 443(d)(1)” on the dotted line to the left of the entry space.
3. Complete lines 8 through 11.
4. Subtract line 11 from line 10. Multiply the result by the number of months in the short period and divide that result by 12. Enter the final result on line 12 and write “Sec. 443(d)(2)” on the dotted line to the left of the entry space.
5. Complete the rest of the form in the normal manner.

ALLOCATING DIFFERENTLY TREATED ITEMS BETWEEN CERTAIN ENTITIES AND THEIR INVESTORS

For a regulated investment company, a real estate investment trust, or a common trust fund, see section 59(d) for details on allocating certain differently treated items between the entity and its investors.

OPTIONAL WRITE-OFF FOR CERTAIN EXPENDITURES

There is no AMT adjustment for the following items if the corporation elects to deduct them ratably over the period of time shown for the regular tax.

- Circulation expenditures (personal holding companies only) – 3 years.
- Mining exploration and development costs – 10 years.
- Intangible drilling costs – 60 months.

See section 59(e) for more details.

III. Specific Instructions

Line 1. Taxable Income or (Loss) Before Net Operating Loss Deduction

Enter the corporation's taxable income or (loss) before the NOL deduction, after the special deductions, and without regard to any excess inclusion (for example, if filing Form 1120, subtract line 29b from line 28 of that form).

Line 2. Adjustments and Preferences

Caution. To avoid duplication, do not include any AMT adjustment or preference taken into account on line 2i, 2j, 2k, or 2o in the amounts to be entered on any other line of this form.

Line 2a. Depreciation of Post-1986 Property

What Adjustments Are Not Included As Depreciation Adjustments?

Do not make a depreciation adjustment on line 2a for:

- A tax shelter farm activity. Take this adjustment into account on line 2i.
- Passive activities. Take this adjustment into account on line 2j.
- An activity for which the corporation is not at risk or income or loss from a partnership interest or stock in an S corporation if the basis limitations apply. Take this adjustment into account on line 2k.

What Depreciation Must Be Refigured for the AMT?

Generally, the corporation must refigure depreciation for the AMT, including depreciation allocable to inventory costs, for:

- Property placed in service after 1998 depreciated for the regular tax using the 200% declining balance method (generally 3-, 5-, 7-, or 10-year property under the modified accelerated cost recovery system (MACRS), except for qualified property eligible for the special depreciation allowance;
- Section 1250 property placed in service after 1998 that is not depreciated for the regular tax using the straight line method; and

- Tangible property placed in service after 1986 and before 1999. (If the transitional election was made under section 203(a)(1)(B) of the Tax Reform Act of 1986, this rule applies to property placed in service after July 31, 1986.)

What Depreciation Is Not Refigured for the AMT?

Do not refigure depreciation for the AMT for the following.

- Residential rental property placed in service after 1998.
- Nonresidential real property with a class life of 27.5 years or more (generally, a building and its structural components) placed in service after 1998 that is depreciated for the regular tax using the straight line method.
- Other section 1250 property placed in service after 1998 that is depreciated for the regular tax using the straight line method.
- Property (other than section 1250 property) placed in service after 1998 that is depreciated for the regular tax using the 150% declining balance method or the straight line method.
- Property for which the corporation elected to use the alternative depreciation system (ADS) of section 168(g) for the regular tax.
- Any qualified property eligible for a special depreciation allowance if the depreciable basis of the property for the AMT is the same as for the regular tax. If the depreciable basis for the AMT is the same as for the regular tax, no adjustment is required for any depreciation figured on the remaining basis of the qualified property. However, if an election is in effect to not have the special allowance apply, the corporation must refigure depreciation for the AMT.
- Any part of the cost of any property that the corporation elected to expense under section 179. The reduction to the depreciable basis of section 179 property by the amount of the section 179 expense deduction is the same for the regular tax and the AMT.
- Certain public utility property (if a normalization method of accounting is not used), motion picture films and video tape, sound recordings, and property that the corporation elects to exclude from MACRS by using a depreciation method based on a term of years, such as the unit-of-production method.
- Qualified Indian reservation property. See section 168(j).
- Qualified revitalization expenditures for a building for which the corporation elected to claim the commercial revitalization deduction.
- Any natural gas gathering line (as defined in section 168(i)(17)) placed in service after April 11, 2005, the original use of which begins with the corporation after April 11, 2005, and which is not under self-construction or subject to a binding contract in existence before April 12, 2005.

How Is Depreciation Refigured for the AMT?

Property placed in service after 1998. Use the same convention and recovery period used for the regular tax. Use the straight line method for section 1250 property. For property other than section 1250 property, use the 150% declining balance method, switching to the straight line method the first tax year it gives a larger deduction.

Property placed in service before 1999. Refigure depreciation for the AMT using ADS, with the same convention used for the regular tax. See the table below for the method and recovery period to use.

Property Placed in Service Before 1999

IF the property is	THEN use the...
Section 1250 property.	Straight line method over 40 years.
Tangible property (other than section 1250 property) depreciated using the straight line method for the regular tax.	Straight line method over the property's AMT class life.
Any other tangible property.	150% declining balance method, switching to the straight line method the first year it gives a larger deduction, over the property's AMT class life.

How is the AMT class life determined? For property placed in service before 1999, the class life used for the AMT is not necessarily the same as the recovery period used for the regular tax.

Tip. See Pub. 946 for tables that can be used to figure AMT depreciation. Rev. Proc. 89-15, 1989-1 C.B. 816, and Pub. 946 have special rules for short tax years and for property disposed of before the end of the recovery period.

How Is the Line 2a Adjustment Figured?

Subtract the AMT deduction for depreciation from the regular tax deduction and enter the result on line 2a. If the AMT deduction is more than the regular tax deduction, enter the difference as a negative amount.

In addition to the AMT adjustment to the deduction for depreciation, also adjust the amount of depreciation that was capitalized, if any, to account for the difference between the rules for the regular tax and the AMT. Include on this line the current year adjustment to taxable income, if any, resulting from the difference.

Line 2b. Amortization of Certified Pollution Control Facilities

For facilities placed in service before 1999, figure the amortization deduction for the AMT using ADS (that is, the straight line method over the facility's class life). For facilities placed in service after 1998, figure the amortization deduction for the AMT under MACRS using the straight line method. Figure the AMT deduction using 100% of the asset's amortizable basis. Do not reduce the corporation's AMT basis by the 20% section 291 adjustment that applied for the regular tax.

Enter the difference between the AMT deduction and the regular tax deduction on line 2b. If the AMT deduction is more than the regular tax deduction, enter the difference as a negative amount.

Line 2c. Amortization of Mining Exploration and Development Costs

Caution. Do not make this adjustment for costs for which the corporation elected the optional 10-year write-off for the regular tax.

For the AMT, the regular tax deductions under sections 616(a) and 617(a) are not allowed. Instead, capitalize these costs and amortize them ratably over a 10-year period beginning with the tax year in which the corporation paid or incurred them. The 10-year amortization applies to 100% of the mining development and exploration costs paid or incurred during the tax year. Do not reduce the corporation's AMT basis by the 30% section 291 adjustment that applied for the regular tax.

If the corporation had a loss on property for which mining exploration and development costs have not been fully amortized for the AMT, the AMT deduction is the smaller of (a) the loss allowable for the costs had they remained capitalized or (b) the remaining costs to be amortized for the AMT.

Subtract the AMT deduction from the regular tax deduction. Enter the result on line 2c. If the AMT deduction is more than the regular tax deduction, enter the difference as a negative amount.

Line 2d. Amortization of Circulation Expenditures

Caution. Do not make this adjustment for expenditures of a personal holding company for which the company elected the optional 3-year write-off for the regular tax.

For the regular tax, circulation expenditures may be deducted in full when paid or incurred. For the AMT, these expenditures must be capitalized and amortized over 3 years beginning with the tax year in which the expenditures were made.

If the corporation had a loss on property for which circulation expenditures have not been fully amortized for the AMT, the AMT deduction is the smaller of (a) the loss allowable for the expenditures had they remained capitalized or (b) the remaining expenditures to be amortized for the AMT.

Subtract the AMT deduction from the regular tax deduction. Enter the result on line 2d. If the AMT deduction is more than the regular tax deduction, enter the difference as a negative amount.

Line 2e. Adjusted Gain or Loss

If, during the tax year, the corporation disposed of property for which it is making (or previously made) any of the adjustments described on lines 2a through 2d above, refigure the property's adjusted basis for the AMT. Then refigure the gain or loss on the disposition.

The property's adjusted basis for the AMT is its cost minus all applicable depreciation or amortization deductions allowed for the AMT during the current tax year and previous tax years. Subtract this AMT basis from the sales price to get the AMT gain or loss.

Dispositions for which line 2i, 2j, and 2k adjustments are made. The corporation may also have gains or losses from lines 2i, 2j, and 2k that must be considered on line 2e. For example, if for the regular tax the corporation reports a loss from the disposition of an asset used in a passive activity, include the loss in the computations for line 2j to determine if any passive activity loss is limited for the AMT. Then, include the AMT passive activity loss allowed that relates to the disposition of the asset on line 2e in determining the corporation's AMT basis adjustment. It may be helpful to refigure the following for the AMT: Form 8810 and related worksheets, Schedule D (Form 1120), Form 4684 (Section B), or Form 4797.

Enter on line 2e the difference between the regular tax gain or loss and the AMT gain or loss. Enter the difference as a negative amount if any of the following apply.

- The AMT gain is less than the regular tax gain.
- The AMT loss exceeds the regular tax loss.
- The corporation has an AMT loss and a regular tax gain.

Line 2f. Long-Term Contracts

For the AMT, the corporation generally must use the percentage-of-completion method described in section 460(b) to determine the taxable income from any long-term contract (defined in section 460(f)). However, this rule does not apply to any home construction contract (as defined in section 460(e)(6)).

For contracts excepted from the percentage-of-completion method for the regular tax by section 460(e)(1), determine the percentage of completion using the simplified procedures for allocating costs outlined in section 460(b)(3).

Subtract the regular tax income from the AMT income. Enter the difference on line 2f. If the AMT income is less than the regular tax income, enter the difference as a negative amount.

Line 2g. Merchant Marine Capital Construction Funds

Amounts deposited in these funds are not deductible for the AMT. Earnings on these funds must be included in gross income for the AMT. If the corporation deducted these amounts or excluded them from income for the regular tax, add them back on line 2g.

Line 2h. Section 833(b) Deduction

This deduction is not allowed for the AMT. If the corporation took this deduction for the regular tax, add it back on line 2h.

Line 2i. Tax Shelter Farm Activities

Caution. Complete this line only if the corporation is a personal service corporation and it has a gain or loss from a tax shelter farm activity that is not a passive activity. If the tax shelter farm activity is a passive activity, include the gain or loss in the computations for line 2j.

Refigure all gains and losses reported for the regular tax from tax shelter farm activities by taking into account any AMT adjustments and preferences. Determine the AMT gain or loss using the rules for the regular tax with the following modifications.

- No loss is allowed except to the extent the personal service corporation is insolvent.
- Do not use a loss in the current tax year to offset gains from other tax shelter farm activities. Instead, suspend any loss and carry it forward indefinitely until the corporation has a gain in a subsequent tax year from that same tax shelter farm activity or it disposes of the activity.

Tip. Keep adequate records for losses that are not deductible (and therefore carried forward) for both the AMT and regular tax.

Enter on line 2i the difference between the AMT gain or loss and the regular tax gain or loss. Enter the difference as a negative amount if the corporation had:

- An AMT loss and a regular tax gain,
- An AMT loss that exceeds the regular tax loss, or
- A regular tax gain that exceeds the AMT gain.

Line 2j. Passive Activities

Caution. This adjustment applies only to closely held corporations and personal service corporations.

Refigure all passive activity gains and losses reported for the regular tax by taking into account the corporation's AMT adjustments and preferences and AMT prior year unallowed losses that apply to that activity.

Determine the corporation's AMT passive activity gain or loss using the same rules used for the regular tax. Generally, no loss is allowed. However, if the corporation is insolvent, losses are allowed to the extent the corporation is insolvent (see section 58(c)).

Disallowed losses of a personal service corporation are suspended until the corporation has income from that (or any other) passive activity or until the passive activity is disposed of (that is, its passive losses cannot offset "net active income" (defined in section 469(e)(2)(B) or "portfolio income")). Disallowed losses of a closely held corporation that is not a personal service corporation are treated the same except that, in addition, they may be used to offset "net active income."

Tip. Keep adequate records for losses that are not deductible (and therefore carried forward) for both the AMT and regular tax.

Enter on line 2j the difference between the AMT gain or loss and the regular tax gain or loss. Enter the difference as a negative amount if the corporation had:

- An AMT loss and a regular tax gain,
- An AMT loss that exceeds the regular tax loss, or
- A regular tax gain that exceeds the AMT gain.

Tax Shelter Farm Activities That Are Passive Activities

Refigure all gains and losses reported for the regular tax by taking into account the corporation's AMT adjustments and preferences and AMT prior year unallowed losses.

Use the same rules as outlined above for other passive activities, with the following modifications.

- AMT gains from tax shelter farm activities that are passive activities may be used to offset AMT losses from other passive activities.
- AMT losses from tax shelter farm activities that are passive activities may not be used to offset AMT gains from other passive activities. These losses must be suspended and carried forward indefinitely until the corporation has a gain in a subsequent year from that same activity or it disposes of the activity.

Line 2k. Loss Limitations

Refigure gains and losses reported for the regular tax from at-risk activities and the corporation's share of distributive items from partnerships by taking into account the corporation's AMT adjustments and preferences. If the corporation has recomputed losses that must be limited for the AMT by section 465 or section 704(d) or the corporation reported losses for the regular tax from at-risk activities or distributive shares of partnership losses that were limited by those sections, figure the difference between the loss limited for the AMT and the loss limited for the regular tax for each applicable at-risk activity or distributive share of partnership loss. "Loss limited" means the amount of loss that is not allowable for the year because of the limitations above.

Enter on line 2k the excess of the loss limited for the AMT over the loss limited for the regular tax. If the loss limited for the regular tax is more than the loss limited for the AMT, enter the difference as a negative amount.

Line 2l. Depletion

Refigure depletion using only income and deductions allowed for the AMT when refiguring the limit based on taxable income from the property under section 613(a) and the limit based on taxable income, with certain adjustments, under section 613A(d)(1). Also, the depletion deduction for mines, wells, and other natural deposits is limited to the property's adjusted basis at the end of the year, as refigured for the AMT, unless the corporation is an independent producer or royalty owner claiming percentage depletion for oil and gas wells. Figure this limit separately for each property. When refiguring the property's adjusted basis, take into account any AMT adjustments the corporation made this year or in previous years that affect basis (other than the current year's depletion). Do not include in the property's adjusted basis any unrecovered costs of depreciable tangible property used to exploit the deposits (for example, machinery, tools, pipes, etc.).

For iron ore and coal (including lignite), apply the section 291 adjustment before figuring this preference.

Enter on line 2l the difference between the regular tax and the AMT deduction. If the AMT deduction is more than the regular tax deduction, enter the difference as a negative amount.

Line 2m. Tax-Exempt Interest Income From Specified Private Activity Bonds

Enter on line 2m interest income from specified private activity bonds, reduced by any deduction that would have been allowable if the interest were includible in gross income for the regular tax. Generally, a specified private activity bond is any private activity bond (as defined in section 141) issued after August 7, 1986, on which the interest is not includible in gross income for the regular tax. Specified private activity bonds do not include qualified 501(c)(3) bonds, certain housing bonds issued after July 30, 2008, and bonds issued after December 31, 2008 and before January 1, 2011. See section 57(a)(5)(C) for more information and other exceptions.

Do not include interest on qualified Gulf Opportunity Zone bonds described in section 1400N(a) or qualified Midwestern disaster area bonds.

Line 2n. Intangible Drilling Costs

Caution. Do not make this adjustment for costs for which the corporation elected the optional 60-month write-off for the regular tax.

Intangible drilling costs (IDCs) from oil, gas, and geothermal properties are a preference to the extent excess IDCs exceed 65% of the net income from the properties. Figure the preference for all geothermal deposits separately from the preference for all oil and gas properties that are not geothermal deposits.

Excess IDCs. Excess IDCs are the excess of:

- The amount of IDCs the corporation paid or incurred for oil, gas, or geothermal properties that it elected to expense for the regular tax (not including any IDCs paid or incurred for nonproductive wells) reduced by the section 291(b)(1) adjustment for integrated oil companies and increased by any IDCs allowed to be amortized under section 291(b)(2) over
- The amount that would have been allowed if the corporation had amortized that amount over a 120-month period starting with the month the well was placed in production or, alternatively, had elected any method that is permissible in determining cost depletion.

Net income from oil, gas, and geothermal properties. Net income is the gross income the corporation received or accrued from all oil, gas, and geothermal wells minus the deductions allocable to these properties (reduced by the excess IDCs). When refiguring net income, use only income and deductions allowed for the AMT.

Exception. The preference for IDCs from oil and gas wells does not apply to corporations that are independent producers (that is, not integrated oil companies as defined in section 291(b)(4)). However, this benefit may be limited. First, figure the IDC

preference as if this exception did not apply. Then, for purposes of this exception, complete a second Form 4626 through line 5, including the IDC preference. If the amount of the IDC preference exceeds 40% of the amount figured for line 5, enter the excess on line 2n (the benefit of this exception is limited). If the amount of the IDC preference is equal to or less than 40% of the amount figured for line 5, do not include an amount on line 2n for oil and gas wells (the benefit of this exception is not limited).

Line 2o. Other Adjustments And Preferences

Enter the net amount of any other adjustments and preferences, including the following.

Income eligible for the American Samoa economic development credit. If this income was included in the corporation's taxable income for the regular tax, include this amount on line 2o as a negative amount.

Income from the alcohol, biodiesel, and renewable diesel fuels credits. If this income was included in the corporation's income for the regular tax, include this amount on line 2o as a negative amount.

Income as the beneficiary of an estate or trust. If the corporation is the beneficiary of an estate or trust, include on line 2o the AMT adjustment from Schedule K-1 (Form 1041), Part III, box 12.

Net AMT adjustment from an electing large partnership. If the corporation is a partner in an electing large partnership, include on line 2o the amount from Schedule K-1 (Form 1065-B), box 6. Also include on line 2o any amount from Schedule K-1 (Form 1065-B), box 5, unless the corporation is a closely held or personal service corporation. Closely held and personal service corporations should take any amount from box 5 into account when figuring the amount to enter on line 2j.

Patron's AMT adjustment. Distributions the corporation received from a cooperative may be includible in income. Unless the distributions are nontaxable, include on line 2o the total AMT patronage dividend adjustment reported to the corporation from the cooperative.

Cooperative's AMT adjustment. If the corporation is a cooperative, refigure the cooperative's deduction for patronage dividends by taking into account the cooperative's AMT adjustments and preferences. Subtract the cooperative's AMT deduction for patronage dividends from its regular tax deduction for patronage dividends and include the result on line 2o. If the AMT deduction is more than the regular tax deduction, include the result as a negative amount.

Domestic production activities deduction. For the AMT, refigure the corporation's domestic production activities deduction under section 199 without taking into account any AMT adjustments and preferences. The section 199 deduction for the corporation's AMT is 6% of the smaller of (a) the qualified production activities income or (b) the alternative minimum taxable income (AMTI), determined without taking into account the section 199 deduction. Subtract the corporation's AMT section 199 deduction from its regular tax section 199 deduction and include the result on line 2o. If the AMT deduction is more than the regular tax deduction, include the result as a negative amount.

Installment sales. The installment method does not apply for the AMT to any nondealer disposition of property that occurred after August 16, 1986, but before the first day of the corporation's tax year that began in 1987, if an installment obligation to which the proportionate disallowance rule applied arose from the disposition. Include as a negative adjustment on line 2o the amount of installment sale income reported for the regular tax.

Accelerated depreciation of real property and certain leased personal property (pre-1987).

Caution. *This preference generally applies only to property placed in service after 1987, but depreciated using pre-1987 rules due to transition provisions of the Tax Reform Act of 1986.*

Refigure depreciation for the AMT using the straight line method for real property for which accelerated depreciation was determined for the regular tax using pre-1987 rules. Use a recovery period of 19 years for 19-year real property and 15 years for low-income housing property. Figure the excess of the regular tax depreciation over the AMT depreciation separately for each property and include only positive adjustments on line 2o.

The adjustment for leased personal property only applies to personal holding companies. For leased personal property other than recovery property, enter the excess of the depreciation claimed for the property for the regular tax using pre-1987 rules over the depreciation allowable for the AMT as refigured using the straight line method.

For leased 10-year recovery property and leased 15-year public utility property, enter the excess of the regular tax depreciation over the depreciation allowable using the straight line method with a half-year convention, no salvage value, and a recovery period of 15 years (22 years for 15-year public utility property).

Figure this amount separately for each property and include only positive adjustments on line 2o.

Related adjustments. AMT adjustments and preferences may affect deductions that are based on an income limit (for example, charitable contributions). Refigure these deductions using the income limit as modified for the AMT. Include on line 2o an adjustment for the difference between the regular tax and AMT amounts for all such deductions. If the AMT deduction is more than the regular tax deduction, include the difference as a negative amount.

Line 4. Adjusted Current Earnings (ACE) Adjustment

Caution. *The ACE adjustment does not apply to a regulated investment company or a real estate investment trust. Also, for an affiliated group filing a consolidated return under the rules of section 1501, figure line 4b on a consolidated basis.*

Line 4b. The following examples illustrate the manner in which line 3 is subtracted from line 4a to get the amount to enter on line 4b.

Example 1. Corporation A has line 4a ACE of \$25,000. If Corporation A has line 3 pre-adjustment AMTI in the amounts shown below, its line 3 and line 4a amounts would be combined as follows to determine the amount to enter on line 4b.

Line 4a ACE	\$25,000	\$25,000	\$25,000
Line 3 pre-adj. AMTI	<u>10,000</u>	<u>30,000</u>	<u>(50,000)</u>
Amount to enter on line 4b	\$15,000	\$(5,000)	\$75,000

Example 2. Corporation B has line 4a ACE of \$(25,000). If Corporation B has line 3 pre-adjustment AMTI in the amounts shown below, its line 3 and line 4a amounts would be combined as follows to determine the amount to enter on line 4b.

Line 4a ACE	\$(25,000)	\$(25,000)	\$(25,000)
Line 3 pre-adj. AMTI	(10,000)	(30,000)	<u>50,000</u>
Amount to enter on line 4b	\$(15,000)	\$5,000	\$(75,000)

Line 4d. A potential negative ACE adjustment (that is, a negative amount on line 4b multiplied by 75%) is allowed as a negative ACE adjustment on line 4e only if the corporation's total increases in AMTI from prior year ACE adjustments exceed its total reductions in AMTI from prior year ACE adjustments (line 4d). The purpose of line 4d is to provide a "running balance" of this limitation amount. As such, the corporation must keep adequate records (for example, a copy of Form 4626 completed at least through line 5) from year to year (even in years in which it does not owe any AMT).

Any potential negative ACE adjustment that is not allowed as a negative ACE adjustment in a tax year because of the line 4d limitation cannot be used to reduce a positive ACE adjustment in any other tax year. Combine lines 4d and 4e of the 2009 Form 4626 and enter the result on line 4d of the 2010 form, but do not enter less than zero.

Example. Corporation C, a calendar-year corporation, was incorporated January 1, 2006. Its ACE and pre-adjustment AMTI for 2006 through 2010 were as follows.

Year	ACE	Pre- adjustment AMTI
2006	\$700,000	\$800,000
2007	900,000	600,000
2008	400,000	500,000
2009	(100,000)	300,000
2010	250,000	100,000

Corporation C subtracts its pre-adjustment AMTI from its ACE in each of the years and then multiplies the result by 75% to get the following potential ACE adjustments for 2006 through 2010.

<u>Year</u>	<u>ACE minus pre-adjustment AMTI</u>	<u>Potential ACE adjustment</u>
2006	\$(100,000)	\$ (75,000)
2007	300,000	225,000
2008	(100,000)	(75,000)
2009	(400,000)	(300,000)
2010	150,000	112,500

Under these facts, Corporation C has the following increases or reductions in AMTI for 2006 through 2010.

<u>Year</u>	<u>Increase or (reduction) in AMTI from ACE adjustment</u>
2006	\$0
2007	225,000
2008	(75,000)
2009	(150,000)
2010	112,500

In 2006, Corporation C was not allowed to reduce its AMTI by any part of the potential negative ACE adjustment because it had no increases in AMTI from prior year ACE adjustments.

In 2007, Corporation C had to increase its AMTI by the full amount of its potential ACE adjustment. It was not allowed to use any part of its 2006 unallowed potential negative ACE adjustment of \$75,000 to reduce its 2007 positive ACE adjustment of \$225,000.

In 2008, Corporation C was allowed to reduce its AMTI by the full amount of its potential negative ACE adjustment because that amount is less than its line 4d limit of \$225,000.

In 2009, Corporation C was allowed to reduce its AMTI by only \$150,000. Its potential negative ACE adjustment of \$300,000 was limited to its 2007 increase in AMTI of \$225,000 minus its 2008 reduction in AMTI of \$75,000.

In 2010, Corporation C must increase its AMTI by the full amount of its potential ACE adjustment. It cannot use any part of its 2009 unallowed potential negative ACE adjustment of \$150,000 to reduce its 2010 positive ACE adjustment of \$112,500. Corporation C would complete the relevant portion of its 2010 Form 4626 as follows.

<u>Line</u>	<u>Amount</u>
4a	\$250,000
4b	150,000
4c	112,500
4d	-0
4e	112,500

Line 6. Alternative Tax Net Operating Loss Deduction (ATNOLD)

The ATNOLD is the sum of the alternative tax net operating loss (ATNOL) carrybacks and carryforwards to the tax year, subject to the limitation explained below. For a corporation that held a residual interest in a real estate mortgage investment conduit (REMIC), figure the ATNOLD without regard to any excess inclusion.

Caution. *NOLs arising in tax years beginning before August 6, 1997, can be carried forward no more than 15 years. Therefore, the corporation cannot carry forward an NOL to the 2010 tax year from a loss year beginning before 1995.*

The ATNOL for a loss year is the excess of the deductions allowed in figuring AMTI (excluding the ATNOLD) over the income included in AMTI. This excess is figured with the modifications in section 172(d), taking into account the adjustments in sections 56 and 58 and preferences in section 57 (that is, the section 172(d) modifications must be separately figured for the ATNOL).

In applying the rules relating to the determination of the amount of carrybacks and carryforwards, use the modification to those rules described in section 56(d)(1)(B)(ii).

The ATNOLD is generally limited to 90% of AMTI determined without regard to the ATNOLD and any domestic production activities deduction under section 199. To figure AMTI without regard to the ATNOLD, use a second Form 4626 as a worksheet. Complete the second Form 4626 through line 5, but when figuring lines 2l and 2o, treat line 6 as if it were zero. The amount figured on line 5 of the second Form 4626 is the corporation's AMTI determined without regard to the ATNOLD. Add any domestic production activities deduction to this tentative total. The ATNOLD limitation is 90% of this amount.

However, if an ATNOL carried back or carried forward to the tax year is attributable to qualified disaster losses (as defined in section 172(j)), qualified Gulf Opportunity Zone losses (as defined in section 1400N(k)(2)), qualified recovery assistance losses (as defined in Pub. 4492-A, Information for Taxpayers Affected by the May 4, 2007 Kansas Storms and Tornadoes), or qualified disaster recovery assistance losses (as defined in Pub. 4492-B), or an applicable 2008 and 2009 NOL for which the corporation elected a 3, 4, or 5-year carryback period (under section 172(b)(1)(H), the ATNOLD for the tax year is limited to the sum of:

1. The smaller of:
 - a. The sum of the ATNOL carrybacks and carryforwards to the tax year attributable to net operating losses other than qualified disaster losses, qualified Gulf Opportunity Zone losses, qualified recovery assistance losses, and qualified disaster recovery assistance losses, and applicable 2008 and 2009 NOLs for which the corporation made the election under section 172(b)(1)(H); or
 - b. Ninety percent of AMTI for the tax year (figured without regard to the ATNOLD, as discussed earlier, and the domestic production activities deduction under section 199) plus

2. The smaller of:
 - a. The sum of the ATNOL carrybacks and carryforwards to the tax year attributable to qualified disaster losses, qualified Gulf Opportunity Zone losses, qualified recovery assistance losses, and qualified disaster recovery assistance losses, and applicable 2008 and 2009 NOLs for which the corporation made the election under section 172(b)(1)(H); or
 - b. 100% of AMTI for the tax year (figured without regard to the ATNOLD, as discussed earlier, and the domestic production activities deduction under section 199) reduced by the amount determined under 1, above.

Enter on line 6 the smaller of the ATNOLD or the ATNOLD limitation. If the corporation made the election under section 172(b)(1)(H) for an applicable 2008 or 2009 NOL, on the dotted line next to line 6, enter "ARRA" (referring to the American Recovery and Reinvestment Act of 2009), or "WHBAA" (referring to the Worker, Homeownership, and Business Assistance Act of 2009).

The ATNOL can be carried back or forward using the rules outlined in section 172(b). An election under section 172(b)(3) to forego the carryback period for the regular tax also applies for the AMT.

The ATNOL carried back or forward may differ from the NOL (if any) that is carried back or forward for the regular tax. Keep adequate records for both the AMT and the regular tax.

Line 7. Alternative Minimum Taxable Income

For a corporation that held a residual interest in a REMIC and is not a thrift institution, line 7 may not be less than the total of the amounts shown on Schedule(s) Q (Form 1066), Quarterly Notice to Residual Interest Holder of REMIC Taxable Income or Net Loss Allocation, line 2c, for the periods included in the corporation's tax year. If the total of the line 2c amounts is larger than the amount the corporation would otherwise enter on line 7, enter that total and write "Sch. Q" on the dotted line next to line 7.

Line 8. Exemption Phase-Out Computation

Line 8a. If this Form 4626 is for a member of a controlled group of corporations, subtract \$150,000 from the combined AMTI of all members of the controlled group. Divide the result among the members of the group in the same manner as the \$40,000 tentative exemption is divided among the members. Enter this member's share on line 8a. The tentative exemption must be divided equally among the members, unless all members consent to a different allocation. See section 1561 for details.

Line 8c. If this Form 4626 is for a member of a controlled group of corporations, reduce the member's share of the \$40,000 tentative exemption by the amount entered on line 8b.

Line 10

Multiply line 9 by 20% (.20) and enter that amount on line 10. However, if the corporation had qualified timber gain, see the instructions below.

Reduction of AMT for corporations with qualified timber gain. If the corporation is a partner in a partnership and had net capital gain and a distributive share of a qualified timber gain (as defined in section 1201(b)(2)) from the partnership for the period that began before May 23, 2009, the corporation may be eligible for a reduced tax on the portion of line 9 attributable to qualified timber gain. See section 55(b)(4). Enter the alternative tax, if any, on line 10. Attach a statement showing the computation. The corporation may use the format of the 2009 Form 4626, Part II, as a guide.

Line 11. Alternative Minimum Tax Foreign Tax Credit (AMTFTC)

The AMTFTC is the foreign tax credit refigured as follows.

1. Complete a separate AMT Form 1118, Foreign Tax Credit – Corporations, for each separate limitation category specified at the top of Form 1118. Include as a separate limitation category dividends received from a corporation that qualifies for the American Samoa economic development credit if the dividends-received deduction for those dividends is disallowed under the ACE rules.

In determining if any income is “high-taxed” in applying the separate limitation categories, use the AMT rate (20%) instead of the regular tax rate.

2. For each separate AMT Form 1118, if the corporation previously made or is making the simplified limitation election (discussed below), skip Schedule A and enter on Schedule B, Part II, line 7, the same amount you entered on that line for the regular tax. Otherwise, complete Schedule A using only income and deductions that are allowed for the AMT and attributable to sources outside the United States.
3. For each separate AMT Form 1118, complete Schedule B, Part II. Enter any AMTFTC carryover on Schedule B, Part II, line 5. Enter the AMTI from Form 4626, line 7, on Schedule B, Part II, line 8a. Enter the amount from Form 4626, line 10, on Schedule B, Part II, line 10. When completing Schedule B, treat as a tax paid to a foreign country 75% of any withholding or income tax paid to American Samoa on dividends received from a corporation that qualifies for the American Samoa economic development credit (if the dividends-received deduction for those dividends is disallowed under the ACE rules).
4. For the AMT Form 1118, complete Schedule B, Part III, Summary of Separate Credits. The total foreign tax credit is the amount on line 6.
5. Enter on Form 4626, line 11, the smaller of:
 - The amount on Form 4626, line 10, or
 - The amount from the AMT Form 1118, Schedule B, Part III, line 6.

The corporation can use any reasonable method, consistently applied, to apportion the disallowed amount among the separate limitation categories (including the general limitation income category). Any AMT foreign tax credit for each separate limitation category that the corporation cannot claim (because of the limitation fraction) is treated as a credit carryback or carryforward for that limitation category under section 904(c). Because these amounts may differ from the amounts that are carried back or forward for the regular tax, keep adequate records for both the AMT and regular tax. When carried

back or forward, the credit is reported on Schedule B, Part II, line 5, of the carryover year's AMT Form 1118 for that separate limitation category.

Simplified Limitation Election

The corporation may elect to use a simplified section 904 limitation to figure its AMTFTC. The corporation must make the election for its first tax year beginning after 1997 for which it claims an AMTFTC. If it does not make the election for that tax year, it may not make the election for a later tax year. Once made, the election applies to all later tax years and may only be revoked with IRS consent.

If the corporation made the election for each of its AMT separate limitations, the corporation uses its separate limitation income or loss that it determined for the regular tax (instead of refiguring the separate limitation income or loss for the AMT, as described earlier).

Line 13

Enter the corporation's regular tax liability (as defined in section 26(b)) minus any foreign tax credit and American Samoa economic development credit (for example, for Form 1120: Schedule J, line 2, minus line 5a and minus any American Samoa economic development credit from Form 5735 included on Schedule J, line 5b). Do not include any:

- Tax on accumulation distribution of trusts from Form 4970,
- Recapture of investment credit (under section 49(b) or 50(a)) from Form 4255,
- Recapture of low-income housing credit (under section 42(j) or (k)) from Form 8611, or
- Recapture of any other credit.

ADJUSTED CURRENT EARNINGS (ACE) WORKSHEET INSTRUCTIONS

Treatment of Certain Ownership Changes

If a corporation with a net unrealized built-in loss (within the meaning of section 382(h)) undergoes an ownership change (within the meaning of section 382(g) and Regulations section 1.56(g)-1(k)(2)), refigure the adjusted basis of each asset of the corporation (immediately after the ownership change). The new adjusted basis of each asset is its proportionate share (based on respective fair market values) of the fair market value of the corporation's assets (determined under section 382(h)) immediately before the ownership change.

To determine if the corporation has a net unrealized built-in loss immediately before an ownership change, use the aggregate adjusted basis of its assets used for figuring its ACE. Also, use these new adjusted bases for all future ACE calculations (such as depreciation and gain or loss on disposition of an asset).

Line 2. ACE Depreciation Adjustment

Line 2a. AMT depreciation. Generally, the amount entered on this line is the depreciation the corporation claimed for the regular tax (Form 4562, line 22), modified by the AMT depreciation adjustments reported on lines 2a and 2o of Form 4626.

Line 2b(1). Post-1993 property. For property placed in service after 1993, the ACE depreciation is the same as the AMT depreciation. Therefore, enter on line 2b(1) the same depreciation expense you included on line 2a of this worksheet for such property.

Line 2b(2). Post-1989, pre-1994 property. For property placed in service in a tax year that began after 1989 and before 1994, use the ADS depreciation described in section 168(g). However, for property (a) placed in service in a tax year that began after 1989 and (b) described in sections 168(f)(1) through (4), use the same depreciation claimed for the regular tax and enter it on line 2b(5).

Line 2b(3). Pre-1990 MACRS property. For MACRS property generally placed in service after 1986 and in a tax year that began before 1990, figure depreciation by using the property's AMT adjusted basis as of the close of the last tax year beginning before 1990 and by using the straight line method over the remainder of the recovery period for the property under ADS. In doing so, use the convention that would have applied to the property under section 168(d). For more information (including an example that illustrates the application of these rules), see Regulations section 1.56(g)-1(b)(2).

Line 2b(4). Pre-1990 original ACRS property. For ACRS property generally placed in service in a tax year that began after 1980 and before 1987, figure depreciation by using the property's regular tax adjusted basis as of the close of the last tax year beginning before 1990 and by using the straight line method over the remainder of the recovery period for the property under ADS. In doing so, use the convention that would have applied to the property under section 168(d) (without regard to section 168(d)(3)). For more information (including an example that illustrates the application of these rules), see Regulations section 1.56(g)-1(b)(3).

Line 2b(5). Property described in sections 168(f)(1) through (4). For this property, use the regular tax depreciation, regardless of when the property was placed in service.

Caution. Line 2b(5) takes priority over lines 2b(1), 2b(2), 2b(3), and 2b(4). For property that is described in sections 168(f)(1) through (4), use line 2b(5) instead of the line 2b(1), 2b(2), 2b(3), or 2b(4) that would otherwise apply.

Line 2b(6). Other property. Use the regular tax depreciation for (a) property placed in service before 1981 and (b) property placed in service after 1980, in a tax year that began before 1990, that is excluded from MACRS by section 168(f)(5)(A)(i) or original ACRS by section 168(e)(4), as in effect before the Tax Reform Act of 1986.

Line 2c. Total ACE depreciation. Subtract line 2b(7) from line 2a and enter the result on line 2c. If line 2b(7) exceeds line 2a, enter the difference as a negative amount.

Line 3. Inclusion in ACE of Items Included in Earnings and Profits (E&P)

In general, any income item that is not taken into account (see below) in determining the corporation's pre-adjustment AMTI but that is taken into account in determining its E&P must be included in ACE. Any such income item can be reduced by all items related to that income item and that would be deductible when figuring pre-adjustment AMTI if the income items to which they relate were included in the corporation's pre-adjustment AMTI for the tax year. Examples of these income items and the adjustments that relate to them include:

- Interest income from tax-exempt obligations excluded under section 103 minus any costs incurred in carrying these tax-exempt obligations and
- Proceeds of life insurance contracts excluded under section 101 minus the basis in the contract for purposes of ACE.

An income item is considered taken into account without regard to the timing of its inclusion in a corporation's pre-adjustment AMTI or its E&P. Only income items that are permanently excluded from pre-adjustment AMTI are included in ACE. An income item will not be considered taken into account merely because the proceeds from that item might eventually be reflected in the pre-adjustment AMTI of another taxpayer (for example, that of a shareholder) on the liquidation or disposal of a business.

Exceptions. Do not make an adjustment for the following.

- Any income from discharge of indebtedness excluded from gross income under section 108 (or the corresponding provision of prior law).
- Any extraterritorial income excluded from gross income under section 114.
- For an insurance company taxed under section 831(b), any amount not included in gross investment income (as defined in section 834(b)).
- Any special subsidy payment for prescription drug plans excluded from gross income under section 139A.
- Any qualified shipping income excluded under section 1357.
- Tax-exempt interest on certain housing bonds excluded under section 57(a)(5)(C)(iii).
- Tax-exempt interest on certain private activity bonds issued after December 31, 2008, and before January 1, 2011. Special rules apply to refunding bonds. See section 56(g)(4)(B)(iv).

Line 3d. Include in ACE the income on life insurance contracts (as determined under section 7702(g)) for the tax year minus the part of any premium attributable to insurance coverage.

Line 3e. Do not include any adjustment related to the E&P effects of any charitable contribution.

Line 4. Disallowance of Items Not Deductible From E&P

Generally, no deduction is allowed when figuring ACE for items not taken into account (see below) in figuring E&P for the tax year. These amounts increase ACE if they are deductible in figuring pre-adjustment AMTI (that is, they would be positive adjustments).

However, there are exceptions. Do not add back:

- Any deduction allowable under section 243 or 245 for any dividend that qualifies for a 100% dividends-received deduction under section 243(a), 245(b), or 245(c) and
- Any dividend received from a 20%-owned corporation (see section 243(c)(2)), but only if the dividend is from income of the paying corporation that is subject to federal income tax.
- Any allowable domestic production activities deduction under section 199.

Special rules apply to the following.

- Dividends from certain possession corporation operating in American Samoa.
- Certain dividends received by certain cooperatives.

An item is considered taken into account without regard to the timing of its deductibility in figuring pre-adjustment AMTI or E&P. Therefore, only deduction items that are permanently disallowed in figuring E&P are disallowed in figuring ACE.

Items for which no adjustment is necessary. Generally, no deduction is allowed for an item in figuring ACE if the item is not deductible in figuring pre-adjustment AMTI (even if the item is deductible in figuring E&P). The only exceptions to this general rule are the related reductions to an income item described in the second sentence of the instructions for line 3. Deductions that are not allowed in figuring ACE include:

- Capital losses that exceed capital gains;
- Bribes, fines, and penalties disallowed under section 162;
- Charitable contributions that exceed the limitations of section 170;
- Meals and entertainment expenses that exceed the limitations of section 274;
- Federal taxes disallowed under section 275; and
- Golden parachute payments that exceed the limitation of section 280G.

Line 4e. Do not include any adjustment related to the E&P effects of any charitable contribution.

Line 5. Other Adjustments

Line 5a. Except as noted below, in figuring ACE, determine the deduction for intangible drilling costs under section 312(n)(2)(A).

Subtract the ACE expense (if any) from the AMT expense (used to figure line 2n of Form 4626) and enter the result on line 5a. If the ACE expense exceeds the AMT amount, enter the result as a negative amount.

Exception. The above rule does not apply to amounts paid or incurred for any oil or gas well by corporations that are independent producers (that is, not integrated oil companies as defined in section 291(b)(4)). If this exception applies, do not enter an amount on line 5a for oil and gas wells.

Line 5b. When figuring ACE, the current year deduction for circulation expenditures under section 173 does not apply. Therefore, treat circulation expenditures for ACE using the case law that existed before section 173 was enacted.

Subtract the ACE expense (if any) from the regular tax expense (for a personal holding company, from the AMT expense used to figure line 2d of Form 4626) and enter the result on line 5b. If the ACE expense exceeds the regular tax amount (for a personal holding company, the AMT amount), enter the result as a negative amount.

Caution. Do not make this adjustment for expenditures for which the corporation elected the optional 3-year write-off under section 59(e) for the regular tax.

Line 5c. When figuring ACE, the amortization provisions of section 248 do not apply. Therefore, charge all organizational expenditures to a capital account and do not take them into account when figuring ACE until the corporation is sold or otherwise disposed of. Enter on line 5c all amortization deductions for organizational expenditures that were taken for the regular tax during the tax year.

Line 5d. The adjustments provided in section 312(n)(4) apply in figuring ACE. See Regulations section 1.56(g)-1(f)(3).

Line 5e. For any installment sale in a tax year that began after 1989, a corporation generally cannot use the installment method to figure ACE. However, it may use the installment method for the applicable percentage (as determined under section 453A) of the gain from any installment sale to which section 453A(a)(1) applies.

Subtract the installment sale income reported for AMT from the ACE income from the sales and enter the result on line 5e. If the ACE income from the sales is less than the AMT amount, enter the difference as a negative amount.

Line 6. Disallowance of Loss on Exchange of Debt Pools

When figuring ACE, a corporation may not recognize any loss on the exchange of any pool of debt obligations for any other pool of debt obligations having substantially the same effective interest rates and maturities. Add back (that is, enter as a positive adjustment) on line 6 any such loss to the extent recognized for the regular tax.

Line 7. Acquisition Expenses of Life Insurance Companies for Qualified Foreign Contracts

For ACE, acquisition expenses of life insurance companies for qualified foreign contracts (as defined in section 807(e)(4) without regard to the treatment of reinsurance contract rules of section 848(e)(5)) must be capitalized and amortized by applying the treatment generally required under generally accepted accounting principles (and as if this rule applied to such contracts for all applicable tax years).

Subtract the ACE expense (if any) from the regular tax expense and enter the result on line 7. If the ACE expense is more than the regular tax expense, enter the result as a negative amount.

Line 8. Depletion

When figuring ACE, the allowance for depletion for any property placed in service in a tax year that began after 1989 generally must be determined under the cost depletion method.

Subtract the ACE expense (if any) from the AMT expense (used to figure line 2l of Form 4626) and enter the result on line 8 of the worksheet. If the ACE expense is more than the AMT amount, enter the result as a negative amount.

Exception. Independent oil and gas producers and royalty owners that figured their regular tax depletion deduction under section 613A(c) do not have an adjustment for ACE purposes.

Line 9. Basis Adjustments in Determining Gain or Loss From Sale or Exchange of Pre-1994 Property

If, during the tax year, the corporation disposed of property for which it is making (or previously made) any of the ACE adjustments, refigure the property's adjusted basis for ACE. Then refigure the property's gain or loss.

Enter the difference between the AMT gain or loss (used to figure line 2e of Form 4626) and the ACE gain or loss. Enter the difference as a negative amount if any of the following apply.

- The ACE gain is less than the AMT gain.
- The ACE loss is more than the AMT loss.
- The corporation had an ACE loss and an AMT gain.

Adjusted Current Earnings (ACE) Worksheet

▶ See ACE Worksheet Instructions (which begin on page 8).

1 Pre-adjustment AMTI. Enter the amount from line 3 of Form 4626		1	
2 ACE depreciation adjustment:			
a AMT depreciation	2a		
b ACE depreciation:			
(1) Post-1993 property	2b(1)		
(2) Post-1989, pre-1994 property	2b(2)		
(3) Pre-1990 MACRS property	2b(3)		
(4) Pre-1990 original ACRS property	2b(4)		
(5) Property described in sections 168(f)(1) through (4)	2b(5)		
(6) Other property	2b(6)		
(7) Total ACE depreciation. Add lines 2b(1) through 2b(6)	2b(7)		
c ACE depreciation adjustment. Subtract line 2b(7) from line 2a		2c	
3 Inclusion in ACE of items included in earnings and profits (E&P):			
a Tax-exempt interest income	3a		
b Death benefits from life insurance contracts	3b		
c All other distributions from life insurance contracts (including surrenders)	3c		
d Inside buildup of undistributed income in life insurance contracts	3d		
e Other items (see Regulations sections 1.56(g)-1(c)(6)(iii) through (ix) for a partial list)	3e		
f Total increase to ACE from inclusion in ACE of items included in E&P. Add lines 3a through 3e		3f	
4 Disallowance of items not deductible from E&P:			
a Certain dividends received	4a		
b Dividends paid on certain preferred stock of public utilities that are deductible under section 247	4b		
c Dividends paid to an ESOP that are deductible under section 404(k)	4c		
d Nonpatronage dividends that are paid and deductible under section 1382(c)	4d		
e Other items (see Regulations sections 1.56(g)-1(d)(3)(i) and (ii) for a partial list)	4e		
f Total increase to ACE because of disallowance of items not deductible from E&P. Add lines 4a through 4e		4f	
5 Other adjustments based on rules for figuring E&P:			
a Intangible drilling costs	5a		
b Circulation expenditures	5b		
c Organizational expenditures	5c		
d LIFO inventory adjustments	5d		
e Installment sales	5e		
f Total other E&P adjustments. Combine lines 5a through 5e		5f	
6 Disallowance of loss on exchange of debt pools		6	
7 Acquisition expenses of life insurance companies for qualified foreign contracts		7	
8 Depletion		8	
9 Basis adjustments in determining gain or loss from sale or exchange of pre-1994 property		9	
10 Adjusted current earnings. Combine lines 1, 2c, 3f, 4f, and 5f through 9. Enter the result here and on line 4a of Form 4626		10	

Alternative Minimum Tax—Corporations

2010

▶ See separate instructions.
 ▶ Attach to the corporation's tax return.

Name	Employer identification number
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Note: See the instructions to find out if the corporation is a small corporation exempt from the alternative minimum tax (AMT) under section 55(e).

1 Taxable income or (loss) before net operating loss deduction					1
2 Adjustments and preferences:					
a Depreciation of post-1986 property					2a
b Amortization of certified pollution control facilities.					2b
c Amortization of mining exploration and development costs					2c
d Amortization of circulation expenditures (personal holding companies only)					2d
e Adjusted gain or loss					2e
f Long-term contracts					2f
g Merchant marine capital construction funds.					2g
h Section 833(b) deduction (Blue Cross, Blue Shield, and similar type organizations only)					2h
i Tax shelter farm activities (personal service corporations only)					2i
j Passive activities (closely held corporations and personal service corporations only)					2j
k Loss limitations					2k
l Depletion					2l
m Tax-exempt interest income from specified private activity bonds					2m
n Intangible drilling costs					2n
o Other adjustments and preferences					2o
3 Pre-adjustment alternative minimum taxable income (AMTI). Combine lines 1 through 2o.					3
4 Adjusted current earnings (ACE) adjustment:					
a ACE from line 10 of the ACE worksheet in the instructions	4a				
b Subtract line 3 from line 4a. If line 3 exceeds line 4a, enter the difference as a negative amount (see instructions)	4b				
c Multiply line 4b by 75% (.75). Enter the result as a positive amount	4c				
d Enter the excess, if any, of the corporation's total increases in AMTI from prior year ACE adjustments over its total reductions in AMTI from prior year ACE adjustments (see instructions). Note: You <i>must</i> enter an amount on line 4d (even if line 4b is positive)	4d				
e ACE adjustment.					
• If line 4b is zero or more, enter the amount from line 4c					
• If line 4b is less than zero, enter the smaller of line 4c or line 4d as a negative amount					4e
5 Combine lines 3 and 4e. If zero or less, stop here; the corporation does not owe any AMT					5
6 Alternative tax net operating loss deduction (see instructions).					6
7 Alternative minimum taxable income. Subtract line 6 from line 5. If the corporation held a residual interest in a REMIC, see instructions					7
8 Exemption phase-out (if line 7 is \$310,000 or more, skip lines 8a and 8b and enter -0- on line 8c):					
a Subtract \$150,000 from line 7 (if completing this line for a member of a controlled group, see instructions). If zero or less, enter -0-	8a				
b Multiply line 8a by 25% (.25).	8b				
c Exemption. Subtract line 8b from \$40,000 (if completing this line for a member of a controlled group, see instructions). If zero or less, enter -0-					8c
9 Subtract line 8c from line 7. If zero or less, enter -0-					9
10 Multiply line 9 by 20% (.20)					10
11 Alternative minimum tax foreign tax credit (AMTFTC) (see instructions)					11
12 Tentative minimum tax. Subtract line 11 from line 10					12
13 Regular tax liability before applying all credits except the foreign tax credit					13
14 Alternative minimum tax. Subtract line 13 from line 12. If zero or less, enter -0-. Enter here and on Form 1120, Schedule J, line 3, or the appropriate line of the corporation's income tax return					14

Form 1120S - U.S. Income Tax Return for an S Corporation

I. What's New

1. Special rule for 2010 start-up costs. For tax years beginning in 2010, a corporation can elect to deduct up to \$10,000 of start-up costs. See section 195(b)(3).
2. The following credits are new for 2010. For details, see the various credit forms and instructions.
 - New hire retention credit (Form 5884-B)
 - Credit for small employer health insurance premiums (Form 8941).
 - Qualifying therapeutic discovery project credit (Form 3468).

II. General Instructions

PURPOSE OF FORM

Form 1120S is used to report the income, deductions, gains, losses, etc., of a domestic corporation or other entity for any tax year covered by an election to be an S corporation. For details about the election, see Form 2553, Election by a Small Business Corporation, and its instructions.

WHO MUST FILE

A corporation or other entity must file Form 1120S if (a) it elected to be an S corporation by filing Form 2553, (b) the IRS accepted the election, and (c) the election remains in effect. After filing Form 2553, you should have received confirmation that Form 2553 was accepted. If you did not receive notification of acceptance or nonacceptance of the election within 2 months of filing Form 2553 (5 months if you checked box Q1 to request a letter ruling), take follow-up action by calling 1-800-829-4933. Do not file Form 1120S for any tax year before the year the election takes effect.

If you have not filed Form 2553, or did not file Form 2553 on time, you may be entitled to relief for a late filed election to be an S corporation. See the Instructions for Form 2553 for details.

TERMINATION OF ELECTION

Once the election is made, it stays in effect until it is terminated. If the election is terminated, the corporation (or a successor corporation) can make another election on Form 2553 only with IRS consent for any tax year before the 5th tax year after the first tax year in which the termination took effect.

An election terminates automatically in any of the following cases:

1. The corporation is no longer a small business corporation as defined in section 1361(b). This kind of termination of an election is effective as of the day the corporation no longer meets the definition of a small business corporation. Attach to Form 1120S for the final year of the S corporation a statement notifying the IRS of the termination and the date it occurred.

2. The corporation, for each of three consecutive tax years, (a) has accumulated earnings and profits and (b) derives more than 25% of its gross receipts from passive investment income as defined in section 1362(d)(3)(C). The election terminates on the first day of the first tax year beginning after the third consecutive tax year. The corporation must pay a tax for each year it has excess net passive income. See the instructions for line 22a for details on how to figure the tax.
3. The election is revoked. An election may be revoked only with the consent of shareholders who, at the time the revocation is made, hold more than 50% of the number of issued and outstanding shares of stock (including non-voting stock). The revocation may specify an effective revocation date that is on or after the day the revocation is filed. If no date is specified, the revocation is effective at the start of a tax year if the revocation is made on or before the 15th day of the 3rd month of that tax year. If no date is specified and the revocation is made after the 15th day of the 3rd month of the tax year, the revocation is effective at the start of the next tax year.

To revoke the election, the corporation must file a statement with the service center where it filed its election to be an S corporation. In the statement, the corporation must notify the IRS that it is revoking its election to be an S corporation. The statement must be signed by each shareholder who consents to the revocation and contain the information required by Regulations section 1.1362-6(a)(3).

A revocation may be rescinded before it takes effect. See Regulations section 1.1362-6(a)(4) for details.

For rules on allocating income and deductions between an S short year and a C short year and other special rules that apply when an election is terminated, see section 1362(e) and Regulations section 1.1362-3.

If an election was terminated under 1 or 2 above, and the corporation believes the termination was inadvertent, the corporation may request permission from the IRS to continue to be treated as an S corporation. See Regulations section 1.1362-4 for the specific requirements that must be met to qualify for inadvertent termination relief.

ELECTRONIC FILING

Corporations can generally electronically file (e-file) Form 1120S, related forms, schedules, and attachments, Form 7004, Form 940 and 941 employment tax returns. Form 1099 and other information returns can also be electronically filed. However, the option to e-file does not apply to certain returns, including:

- Returns with precomputed penalty and interest,
- Returns with reasonable cause for failing to file timely,
- Returns with reasonable cause for failing to pay timely, and
- Returns with request for overpayment to be applied to another account.

Required filers. Certain corporations with total assets of \$10 million or more that file at least 250 returns a year are required to e-file Form 1120S. See Temporary Regulations section 301.6037-2T. However, these corporations can request a waiver of the electronic filing requirements.

Visit www.irs.gov/efile for details.

WHEN TO FILE

Generally, an S corporation must file Form 1120S by the 15th day of the 3rd month after the end of its tax year. For calendar year corporations, the due date is March 15, 2010. A corporation that has dissolved must generally file by the 15th day of the 3rd month after the date it dissolved.

If the due date falls on a Saturday, Sunday, or legal holiday, file on the next business day.

If the S corporation election was terminated during the tax year and the corporation reverts to a C corporation, file Form 1120S for the S corporation's short year by the due date (including extensions) of the C corporation's short year return.

Extension of Time to File

File Form 7004, Application for Automatic 6-Month Extension of Time To File Certain Business Income Tax, Information, and Other Returns, to request a 6-month extension of time to file. Generally, file Form 7004 by the regular due date of the return. Form 7004 can be filed electronically.

WHO MUST SIGN

The return must be signed and dated by:

- The president, vice president, treasurer, assistant treasurer, chief accounting officer, or
- Any other corporate officer (such as tax officer) authorized to sign.

If a return is filed on behalf of a corporation by a receiver, trustee, or assignee, the fiduciary must sign the return, instead of the corporate officer. Returns and forms signed by a receiver or trustee in bankruptcy on behalf of a corporation must be accompanied by a copy of the order or instructions of the court authorizing signing of the return or form.

If an employee of the corporation completes Form 1120S, the paid preparer's space should remain blank. In addition, anyone who prepares Form 1120S, but does not charge the corporation, should not complete that section. Generally, anyone who is paid to prepare the return must sign it and fill in the "Paid Preparer's Use Only" area.

The paid preparer must complete the required preparer information and:

- Sign the return in the space provided for the preparer's signature.
- Give a copy of the return to the taxpayer.

TAX PAYMENTS

The corporation must pay the tax due in full no later than the 15th day of the 3rd month after the end of the tax year. The two methods of depositing corporate income taxes are discussed below.

Electronic Deposit Requirement

Beginning January 1, 2011, corporations must use electronic funds transfers to make all federal tax deposits (such as deposits of employment, excise, and corporate income tax). Forms 8109 and 8109-B, Federal Tax Coupon, cannot be used after December 31, 2010. Generally, electronic funds transfers are made using the Electronic Federal Tax Payment System (EFTPS). However, if the corporation does not want to use EFTPS, it can arrange for its tax professional, financial institution, payroll service, or other trusted third party to make deposits on its behalf. Also, it may arrange for its financial institution to initiate a same-day tax wire payment (discussed below) on its behalf. EFTPS is a free service provided by the Department of the Treasury. Services provided by a tax professional, financial institution, payroll service, or other third party may have a fee.

Depositing on time. For deposits made by EFTPS to be on time, the corporation must initiate the deposit by 8 p.m. Eastern time the day before the date the deposit is due. If the corporation uses a third party to make deposits on its behalf, they may have different cutoff times.

Same-day wire payment option. If the corporation fails to initiate a deposit transaction on EFTPS by 8 p.m. Eastern time the day before the date a deposit is due, it can still make the deposit on time by using the Federal Tax Application (FTA). Before using the same-day wire payment option, the corporation will need to make arrangements with its financial institution ahead of time.

ESTIMATED TAX PAYMENTS

Generally, the corporation must make installment payments of estimated tax for the following taxes if the total of these taxes is \$500 or more: (a) the tax on built-in gains, (b) the excess net passive income tax, and (c) the investment credit recapture tax.

The amount of estimated tax required to be paid annually is the smaller of: (a) the total of the above taxes shown on the return for the tax year (or if no return is filed, the total of these taxes for the year) or (b) the sum of (i) the investment credit recapture tax and the built-in gains tax shown on the return for the tax year (or if no return is filed, the total of these taxes for the tax year) and (ii) any excess net passive income tax shown on the corporation's return for the preceding tax year. If the preceding tax year was less than 12 months, the estimated tax must be determined under (a).

The estimated tax is generally payable in four equal installments. However, the corporation may be able to lower the amount of one or more installments by using the annualized income installment method or adjusted seasonal installment method under section 6655(e).

For a calendar year corporation, the payments are due for 2010 by April 15, June 15, September 15, and December 15. For a fiscal year corporation, they are due by the 15th day of the 4th, 6th, 9th, and 12th months of the fiscal year. If any date falls on a Saturday, Sunday, or legal holiday, the installment is due on the next regular business day.

The corporation must make the payments using electronic funds transfers described previously.

INTEREST AND PENALTIES

Interest. Interest is charged on taxes paid late even if an extension of time to file is granted. Interest is also charged on penalties imposed for failure to file, negligence, fraud, substantial valuation misstatements, and substantial understatements of tax from the due date (including extensions) to the date of payment. The interest charge is figured at a rate determined under section 6621.

Late filing of return. A penalty may be charged if the return is filed after the due date (including extensions) or the return does not show all the information required, unless each failure is due to reasonable cause. If the failure is due to reasonable cause, attach an explanation to the return. For returns on which no tax is due, the penalty is \$89 for each month or part of a month (up to 12 months) the return is late or does not include the required information, multiplied by the total number of persons who were shareholders in the corporation during any part of the corporation's tax year for which the return is due. If tax is due, the penalty is the amount stated above plus 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax, or if the return is more than 60 days late, a \$135 minimum or the balance of the tax due on the return, whichever is smaller.

Late payment of tax. A corporation that does not pay the tax when due generally may be penalized $\frac{1}{2}$ of 1% of the unpaid tax for each month or part of a month the tax is not paid, up to a maximum of 25% of the unpaid tax. The penalty will not be imposed if the corporation can show that the failure to pay on time was due to reasonable cause.

Failure to furnish information timely. For each failure to furnish Schedule K-1 to a shareholder when due and each failure to include on Schedule K-1 all the information required to be shown (or the inclusion of incorrect information), a \$100 penalty may be imposed with regard to each Schedule K-1 for which a failure occurs. If the requirement to report correct information is intentionally disregarded, each \$100 penalty is increased to \$250 or, if greater, 10% of the aggregate amount of items required to be reported.

The penalty will not be imposed if the corporation can show that not furnishing information timely was due to reasonable cause.

ACCOUNTING METHODS

Figure income using the method of accounting regularly used in keeping the corporation's books and records. The method used must clearly reflect income. Permissible methods include cash, accrual, or any other method authorized by the Internal Revenue Code.

The following rules apply.

- Generally, an S corporation cannot use the cash method of accounting if it is a tax shelter (as defined in section 448(d)(3)). See section 448 for details.
- Unless it is a qualifying taxpayer or a qualifying small business taxpayer, a corporation must use the accrual method for sales and purchases of inventory items. See *Schedule A. Cost of Goods Sold*.
- Special rules apply to long-term contracts. See section 460.

- Generally, dealers in securities must use the mark-to-market accounting method. Dealers in commodities and traders in securities and commodities can elect to use the mark-to-market accounting method. See section 475.

Change in accounting method. To change its method of accounting used to report income (for income as a whole or for the treatment of any material item), the corporation must file Form 3115, Application for Change in Accounting Method.

Note. If the corporation is filing an application for a change in accounting method filed on or after January 10, 2011, for a year of change ending on or after April 30, 2010, see Rev. Proc. 2011-14, 2011-4 I.R.B. 330.

ACCOUNTING PERIOD

A corporation must figure its taxable income on the basis of a tax year. A tax year is the annual accounting period a corporation uses to keep its records and report its income and expenses.

An S corporation must use one of the following tax years.

- A tax year ending December 31.
- A natural business year.
- An ownership tax year.
- A tax year elected under section 444.
- A 52-53 week tax year that ends with reference to a year listed above.
- Any other tax year (including a 52-53-week tax year) for which the corporation establishes a business purpose.

A new S corporation must use Form 2553 to elect a tax year. To later change the corporation's tax year, see Form 1128, Application To Adopt, Change, or Retain a Tax Year, and its instructions (unless the corporation is making an election under section 444, discussed below).

Electing a tax year under section 444.

Under the provisions of section 444, an S corporation may elect to have a tax year other than a permitted year, but only if the deferral period of the tax year is not longer than the shorter of 3 months or the deferral period of the tax year being changed. This election is made by filing Form 8716, Election To Have a Tax Year Other Than a Required Tax Year.

An S corporation may not make or continue an election under section 444 if it is a member of a tiered structure, other than a tiered structure that consists entirely of partnerships and S corporations that have the same tax year. For the S corporation to have a section 444 election in effect, it must make the payments required by section 7519. See Form 8752, Required Payment or Refund Under Section 7519.

A section 444 election ends if an S corporation:

- Changes its accounting period to a calendar year or some other permitted year,
- Is penalized for willfully failing to comply with the requirements of section 7519, or
- Terminates its S election is terminated (unless it immediately becomes a personal service corporation).

If the termination results in a short tax year, type or legibly print at the top of the first page of Form 1120S for the short tax year, "SECTION 444 ELECTION TERMINATED."

PASSIVE ACTIVITY LIMITATIONS

In general, section 469 limits the amount of losses, deductions, and credits that shareholders may claim from "passive activities." The passive activity limitations do not apply to the corporation. Instead, they apply to each shareholder's share of any income or loss and credit attributable to a passive activity. Because the treatment of each shareholder's share of corporate income or loss and credit depends upon the nature of the activity that generated it, the corporation must report income or loss and credits separately for each activity.

The instructions below and the instructions for Schedules K and K-1 explain the applicable passive activity limitation rules and specify the type of information the corporation must provide to its shareholders for each activity. If the corporation had more than one activity, it must report information for each activity on an attachment to Schedules K and K-1.

Generally, passive activities include: (a) activities that involve the conduct of a trade or business in which the shareholder does not materially participate and (b) all rental activities (defined below) regardless of the shareholder's participation. For exceptions, see *Activities That Are Not Passive Activities*. The level of each shareholder's participation in an activity must be determined by the shareholder.

The passive activity rules provide that losses and credits from passive activities can generally be applied only against income and tax from passive activities. Thus, passive losses and credits cannot be applied against income from salaries, wages, professional fees, or a business in which the shareholder materially participates; against "portfolio income"; or against the tax related to any of these types of income.

Special rules require that net income from certain activities that would otherwise be treated as passive income must be recharacterized as nonpassive income for purposes of the passive activity limitations.

To allow each shareholder to apply the passive activity limitations at their level, the corporation must report income or loss and credits separately for each of the following: trade or business activities, rental real estate activities, rental activities other than rental real estate, and portfolio income.

Activities That Are Not Passive Activities

The following are not passive activities:

1. Trade or business activities in which the shareholder materially participated for the tax year.
2. Any rental real estate activity in which the shareholder materially participated if the shareholder met both of the following conditions for the tax year:
 - a. More than half of the personal services the shareholder performed in trades or businesses were performed in real property trades or businesses in which he or she materially participated.
 - b. The shareholder performed more than 750 hours of services in real property trades or businesses in which he or she materially participated.

For purposes of this rule, each interest in rental real estate is a separate activity unless the shareholder elects to treat all interests in rental real estate as one activity.

If the shareholder is married filing jointly, either the shareholder or his or her spouse must separately meet both of the above conditions, without taking into account services performed by the other spouse.

A real property trade or business is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Services the shareholder performed as an employee are not treated as performed in a real property trade or business unless he or she owned more than 5% of the stock in the employer.

3. The rental of a dwelling unit used by a shareholder for personal purposes during the year for more than the greater of 14 days or 10% of the number of days that the residence was rented at fair rental value.
4. An activity of trading personal property for the account of owners of interests in the activity. For purposes of this rule, personal property means property that is actively traded, such as stocks, bonds, and other securities. See Temporary Regulations section 1.469-1T(e)(6) for more details.

Rental Activities

Generally, except as noted below, if the gross income from an activity consists of amounts paid principally for the use of real or personal tangible property held by the corporation, the activity is a rental activity.

There are several exceptions to this general rule. Under these exceptions, an activity involving the use of real or personal tangible property is not a rental activity if any of the following apply:

- The average period of customer use (defined below) for such property is 7 days or less.
- The average period of customer use for such property is 30 days or less and significant personal services (defined below) are provided by or on behalf of the corporation.
- Extraordinary personal services (defined below) are provided by or on behalf of the corporation.
- Rental of the property is treated as incidental to a nonrental activity of the corporation under Temporary Regulations section 1.469-1T(e)(3)(vi) and Regulations section 1.469-1(e)(3)(vi).

- The corporation customarily makes the property available during defined business hours for nonexclusive use by various customers.
- The corporation provides property for use in a nonrental activity of a partnership in its capacity as an owner of an interest in such partnership. Whether the corporation provides property used in an activity of a partnership in the corporation's capacity as an owner of an interest in the partnership is based on all the facts and circumstances.

In addition, a guaranteed payment described in section 707(c) is never income from a rental activity.

Average period of customer use. Figure the average period of customer use for a class of property by dividing the total number of days in all rental periods by the number of rentals during the tax year. If the activity involves renting more than one class of property, multiply the average period of customer use of each class by the ratio of the gross rental income from that class to the activity's total gross rental income. The activity's average period of customer use equals the sum of these class-by-class average periods weighted by gross income. See Regulations section 1.469-1(e)(3)(iii).

Significant personal services. Personal services include only services performed by individuals. To determine if personal services are significant personal services, consider all of the relevant facts and circumstances. Relevant facts and circumstances include:

- How often the services are provided,
- The type and amount of labor required to perform the services, and
- The value of the services in relation to the amount charged for the use of the property.

The following services are not considered in determining whether personal services are significant:

- Services necessary to permit the lawful use of the rental property.
- Services performed in connection with improvements or repairs to the rental property that extend the useful life of the property substantially beyond the average rental period.
- Services provided in connection with the use of any improved real property that are similar to those commonly provided in connection with long-term rentals of high-grade commercial or residential property. Examples include cleaning and maintenance of common areas, routine repairs, trash collection, elevator service, and security at entrances.

Extraordinary personal services. Services provided in connection with making rental property available for customer use are extraordinary personal services only if the services are performed by individuals and the customers' use of the rental property is incidental to their receipt of the services.

For example, a patient's use of a hospital room generally is incidental to the care that the patient receives from the hospital's medical staff. Similarly, a student's use of a dormitory room in a boarding school is incidental to the personal services provided by the school's teaching staff.

Rental property incidental to a nonrental activity. An activity is not a rental activity if the rental of the property is incidental to a nonrental activity, such as the activity of holding property for investment, a trade or business activity, or the activity of dealing in property.

Rental of property is incidental to an activity of holding property for investment if both of the following apply:

- The main purpose for holding the property is to realize a gain from the appreciation of the property.
- The gross rental income from such property for the tax year is less than 2% of the smaller of the property's unadjusted basis or its fair market value.

Rental of property is incidental to a trade or business activity if all of the following apply:

- The corporation owns an interest in the trade or business at all times during the year.
- The rental property was mainly used in the trade or business activity during the tax year or during at least 2 of the 5 preceding tax years.
- The gross rental income from the property is less than 2% of the smaller of the property's unadjusted basis or its fair market value.

The sale or exchange of property that is also rented during the tax year (in which the gain or loss is recognized) is treated as incidental to the activity of dealing in property if, at the time of the sale or exchange, the property was held primarily for sale to customers in the ordinary course of the corporation's trade or business.

Reporting of rental activities. In reporting the corporation's income or losses and credits from rental activities, the corporation must separately report (a) rental real estate activities and (b) rental activities other than rental real estate activities.

Shareholders who actively participate in a rental real estate activity may be able to deduct part or all of their rental real estate losses (and the deduction equivalent of rental real estate credits) against income (or tax) from nonpassive activities. Generally, the combined amount of rental real estate losses and the deduction equivalent of rental real estate credits from all sources (including rental real estate activities not held through the corporation) that may be claimed is limited to \$25,000.

Report rental real estate activity income (loss) on Form 8825, Rental Real Estate Income and Expenses of a Partnership or an S Corporation, and on line 2 of Schedule K and in box 2 of Schedule K-1, rather than on page 1 of Form 1120S. Report credits related to rental real estate activities on lines 13c and 13d of Schedule K (box 13, codes E and F, of Schedule K-1) and low-income housing credits on lines 13a and 13b of Schedule K (box 13, codes A, B, C, and D of Schedule K-1).

Report income (loss) from rental activities other than rental real estate on line 3 and credits related to rental activities other than rental real estate on line 13e of Schedule K and in box 13, code G, of Schedule K-1.

Portfolio Income

Generally, portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business, that is attributable to interest; dividends; royalties; income from a real estate investment trust, a regulated investment company, a real estate mortgage investment conduit, a common trust fund, a controlled foreign corporation, a qualified electing fund, or a cooperative; income from the disposition of property that produces income of a type defined as portfolio income; and income from the disposition of property held for investment. See *Self-Charged Interest* below for an exception.

Solely for purposes of the preceding paragraph, gross income derived in the ordinary course of a trade or business includes (and portfolio income, therefore, does not include) only the following types of income:

- Interest income on loans and investments made in the ordinary course of a trade or business of lending money.
- Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business.
- Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies.
- Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (unless the dealer held the property for investment at any time before such income or gain is recognized).
- Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property.
- Amounts included in the gross income of a patron of a cooperative by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron.
- Other income identified by the IRS as income derived by the taxpayer in the ordinary course of a trade or business.

Report portfolio income and related deductions on Schedule K rather than on page 1 of Form 1120S.

Self-Charged Interest

Certain self-charged interest income and deductions may be treated as passive activity gross income and passive activity deductions if the loan proceeds are used in a passive activity. Generally, self-charged interest income and deductions result from loans between the corporation and its shareholders. Self-charged interest also occurs in loans between the corporation and another S corporation or partnership if each owner in the borrowing entity has the same proportional ownership interest in the lending entity.

The self-charged interest rules do not apply to a shareholder's interest in an S corporation if the S corporation makes an election under Regulations section 1.469-7(g) to avoid the application of these rules. To make the election, the S corporation must

attach to its original or amended Form 1120S a statement that includes the name, address, and EIN of the S corporation and a declaration that the election is being made under Regulations section 1.469-7(g). The election will apply to the tax year for which it was made and all subsequent tax years. Once made, the election may only be revoked with the consent of the IRS.

Grouping of Activities

Generally, one or more trade or business or rental activities may be treated as a single activity if the activities make up an appropriate economic unit for measurement of gain or loss under the passive activity rules. Whether activities make up an appropriate economic unit depends on all the relevant facts and circumstances. The factors given the greatest weight in determining whether activities make up an appropriate economic unit are:

1. Similarities and differences in types of trades or businesses,
2. The extent of common control,
3. The extent of common ownership,
4. Geographical location, and
5. Reliance between or among the activities.

Example. The corporation has a significant ownership interest in a bakery and a movie theater in Baltimore and in a bakery and a movie theater in Philadelphia. Depending on the relevant facts and circumstances, there may be more than one reasonable method for grouping the corporation's activities. For instance, the following groupings may or may not be permissible:

- A single activity.
- A movie theater activity and a bakery activity.
- A Baltimore activity and a Philadelphia activity.
- Four separate activities.

Once the corporation chooses a grouping under these rules, it must continue using that grouping in later tax years unless either the corporation determines that the original grouping was clearly inappropriate or a material change in the facts and circumstances makes it clearly inappropriate.

The IRS may regroup the corporation's activities if the corporation's grouping fails to reflect one or more appropriate economic units and one of the primary purposes for the grouping is to avoid the passive activity limitations.

Limitation on grouping certain activities. The following activities may not be grouped together:

1. A rental activity with a trade or business activity unless the activities being grouped together make up an appropriate economic unit and:
 - a. The rental activity is insubstantial relative to the trade or business activity or vice versa or
 - b. Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity. If so, the portion of the rental activity involving the rental of property to be used in the trade or business activity may be grouped with the trade or business activity.

2. An activity involving the rental of real property with an activity involving the rental of personal property (except for personal property provided in connection with real property or vice versa).
3. Any activity with another activity in a different type of business and in which the corporation holds an interest as a limited partner or as a limited entrepreneur (as defined in section 464(e)(2)) if that other activity engages in holding, producing, or distributing motion picture films or videotapes; farming; leasing section 1245 property; or exploring for, or exploiting, oil and gas resources, or geothermal deposits.

Activities conducted through partnerships. Once a partnership determines its activities under these rules, the corporation as a partner may use these rules to group those activities with:

- Each other,
- Activities conducted directly by the corporation, or
- Activities conducted through other partnerships.

The corporation cannot treat as separate activities those activities grouped together by a partnership.

Recharacterization of Passive Income

Under Temporary Regulations section 1.469-2T(f) and Regulations section 1.469-2(f), net passive income from certain passive activities must be treated as nonpassive income. Net passive income is the excess of an activity's passive activity gross income over its passive activity deductions (current year deductions and prior year unallowed losses).

Income from the following six sources is subject to recharacterization.

Note. Any net passive income recharacterized as nonpassive income is treated as investment income for purposes of figuring investment interest expense limitations if it is from (a) an activity of renting substantially nondepreciable property from an equity-financed lending activity or (b) an activity related to an interest in a pass-through entity that licenses intangible property.

1. **Significant participation passive activities.** A significant participation passive activity is any trade or business activity in which the shareholder participated for more than 100 hours during the tax year but did not materially participate. Because each shareholder must determine his or her level of participation, the corporation will not be able to identify significant participation passive activities.
2. **Certain nondepreciable rental property activities.** Net passive income from a rental activity is nonpassive income if less than 30% of the unadjusted basis of the property used or held for use by customers in the activity is subject to depreciation under section 167.
3. **Passive equity-financed lending activities.** If the corporation has net income from a passive equity-financed lending activity, the smaller of the net passive income or equity-financed interest income from the activity is nonpassive income.

Note. The amount of income from the activities in items 1 through 3 above that any shareholder will be required to recharacterize as nonpassive income may be limited under Temporary Regulations section 1.469-2T(f)(8). Because the corporation will not have information regarding all of a shareholder's activities, it must identify all corporate activities meeting the definitions in items 2 and 3 as activities that may be subject to recharacterization.

4. **Rental of property incidental to a development activity.** Net rental activity income is the excess of passive activity gross income from renting or disposing of property over passive activity deductions (current year deductions and prior year unallowed losses) that are reasonably allocable to the rented property. Net rental activity income is nonpassive income for a shareholder if all of the following apply:
- The corporation recognizes gain from the sale, exchange, or other disposition of the rental property during the tax year.
 - The use of the item of property in the rental activity started less than 12 months before the date of disposition. The use of an item of rental property begins on the first day on which (a) the corporation owns an interest in the property, (b) substantially all of the property is either rented or held out for rent and ready to be rented, and (c) no significant value-enhancing services remain to be performed.
 - The shareholder materially participated or significantly participated for any tax year in an activity that involved the performing of services to enhance the value of the property (or any other item of property, if the basis of the property disposed of is determined in whole or in part by reference to the basis of that item of property).

Because the corporation cannot determine a shareholder's level of participation, the corporation must identify net income from property described above (without regard to the shareholder's level of participation) as income that may be subject to recharacterization.

5. **Rental of property to a nonpassive activity.** If a taxpayer rents property to a trade or business activity in which the taxpayer materially participates, the taxpayer's net rental activity income (defined in item 4) from the property is nonpassive income.
6. **Acquisition of an interest in a pass-through entity that licenses intangible property.** Generally, net royalty income from intangible property is nonpassive income if the taxpayer acquired an interest in the pass-through entity after it created the intangible property or performed substantial services or incurred substantial costs in developing or marketing the intangible property. Net royalty income is the excess of passive activity gross income from licensing or transferring any right in intangible property over passive activity deductions (current year deductions and prior year unallowed losses) that are reasonably allocable to the intangible property.

Passive Activity Reporting Requirements

To allow shareholders to correctly apply the passive activity loss and credit limitation rules, any corporation that carries on more than one activity must:

1. Provide an attachment for each activity conducted through the corporation that identifies the type of activity conducted (trade or business, rental real estate, rental activity other than rental real estate, or investment).
2. On the attachment for each activity, provide a schedule, using the same box numbers as shown on Schedule K-1, detailing the net income (loss), credits, and all items required to be separately stated under section 1366(a)(1) from each trade or business activity, from each rental real estate activity, from each rental activity other than a rental real estate activity, and from investments.
3. Identify the net income (loss) and the shareholder's share of corporation interest expense from each activity of renting a dwelling unit that any shareholder uses for personal purposes during the year for more than the greater of 14 days or 10% of the number of days that the residence is rented at fair rental value.
4. Identify the net income (loss) and the shareholder's share of interest expense from each activity of trading personal property conducted through the corporation.
5. For any gain (loss) from the disposition of an interest in an activity or of an interest in property used in an activity (including dispositions before 1987 from which gain is being recognized after 1986):
 - a. Identify the activity in which the property was used at the time of disposition;
 - b. If the property was used in more than one activity during the 12 months preceding the disposition, identify the activities in which the property was used and the adjusted basis allocated to each activity; and
 - c. For gains only, if the property was substantially appreciated at the time of the disposition and the applicable holding period specified in Regulations section 1.469-2(c)(2)(iii)(A) was not satisfied, identify the amount of the nonpassive gain and indicate whether or not the gain is investment income under Regulations section 1.469-2(c)(2)(iii)(F).
6. Specify the amount of gross portfolio income, the interest expense properly allocable to portfolio income, and expenses other than interest expense that are clearly and directly allocable to portfolio income.
7. Identify the ratable portion of any section 481 adjustment (whether a net positive or a net negative adjustment) allocable to each corporate activity.
8. Identify any gross income from sources specifically excluded from passive activity gross income, including:
 - a. Income from intangible property, if the shareholder is an individual whose personal efforts significantly contributed to the creation of the property;
 - b. Income from state, local, or foreign income tax refunds; and
 - c. Income from a covenant not to compete, if the shareholder is an individual who contributed the covenant to the corporation.
9. Identify any deductions that are not passive activity deductions.

10. If the corporation makes a full or partial disposition of its interest in another entity, identify the gain (loss) allocable to each activity conducted through the entity, and the gain allocable to a passive activity that would have been recharacterized as nonpassive gain had the corporation disposed of its interest in property used in the activity (because the property was substantially appreciated at the time of the disposition, and the gain represented more than 10% of the shareholder's total gain from the disposition).
11. Identify the following items from activities that may be subject to the recharacterization rules under Temporary Regulations section 1.469-2T(f) and Regulations section 1.469-2(f):
 - a. Net income from an activity of renting substantially nondepreciable property;
 - b. The smaller of equity-financed interest income or net passive income from an equity-financed lending activity;
 - c. Net rental activity income from property developed (by the shareholder or the corporation), rented, and sold within 12 months after the rental of the property commenced;
 - d. Net rental activity income from the rental of property by the corporation to a trade or business activity in which the shareholder had an interest (either directly or indirectly); and
 - e. Net royalty income from intangible property if the shareholder acquired the shareholder's interest in the corporation after the corporation created the intangible property or performed substantial services or incurred substantial costs in developing or marketing the intangible property.
12. Identify separately the credits from each activity conducted by or through the corporation.
13. Identify the shareholder's pro rata share of the corporation's self-charged interest income or expense (See *Self-Charged Interest*).
 - a. **Loans between a shareholder and the corporation.** Identify the lending or borrowing shareholder's share of the self-charged interest income or expense. If the shareholder made the loan to the corporation, also identify the activity in which the loan proceeds were used. If the proceeds were used in more than one activity, allocate the interest to each activity based on the amount of the proceeds used in each activity.
 - b. **Loans between the corporation and another S corporation or partnership.** If the corporation's shareholders have the same proportional ownership interest in the corporation and the other S corporation or partnership, identify each shareholder's share of the interest income or expense from the loan. If the corporation was the borrower, also identify the activity in which the loan proceeds were used. If the proceeds were used in more than one activity, allocate the interest to each activity based on the amount of the proceeds used in each activity.

III. Specific Instructions

These instructions follow the line numbers on the first page of Form 1120S. The accompanying schedules are discussed separately.

PERIOD COVERED

File the 2010 return for calendar year 2010 and fiscal years that begin in 2010 and end in 2011. For a fiscal or short tax year return, fill in the tax year space at the top of the form.

The 2010 Form 1120S can also be used if:

- The corporation has a tax year of less than 12 months that begins and ends in 2011, and
- The 2011 Form 1120S is not available at the time the corporation is required to file its return.

The corporation must show its 2011 tax year on the 2010 Form 1120S and take into account any tax law changes that are effective for tax years beginning after December 31, 2010.

Item C. Schedule M-3 Information

A corporation with total assets of \$10 million or more on the last day of the tax year must complete Schedule M-3 (Form 1120S), Net Income (Loss) Reconciliation for S Corporations With Total Assets of \$10 Million or More, instead of Schedule M-1. A corporation filing Form 1120S that is not required to file Schedule M-3 may voluntarily file Schedule M-3 instead of Schedule M-1.

If you are filing Schedule M-3, check the "Check if Sch. M-3 attached" box. See the Instructions for Schedule M-3 for more details.

Item D. Employer Identification Number (EIN)

Enter the corporation's EIN. If the corporation does not have an EIN, it must apply for one. An EIN may be applied for:

- Online – Click on the EIN link at www.irs.gov/businesses/small. The EIN is issued immediately once the application information is validated.
- By telephone at 1-800-829-4933 from 7:00 am to 10:00 pm in the corporation's local time zone.
- By mailing or faxing Form SS-4, Application for Employer Identification Number.

If the corporation has not received its EIN by the time the return is due, enter "Applied for" and the date the corporation applied in the space for the EIN. However, if the corporation is filing its returns electronically, an EIN is required at the time the return is filed.

Item F. Total Assets

Enter the corporation's total assets at the end of the tax year, as determined by the accounting method regularly used in maintaining the corporation's books and records. If there were no assets at the end of the tax year, enter "0".

If the corporation is required to complete Schedule L, enter total assets from Schedule L, line 15, column (d) on page 1, item F. If the S election terminated during the tax year, see the instructions for Schedule L for special rules that may apply when figuring the corporation's year-end assets.

Item H. Final Return, Name Change, Address Change, Amended Return, or S Election Termination or Revocation

- If this is the corporation's final return and it will no longer exist, check the "Final return" box. Also check the "Final K-1" box on each Schedule K-1.
- If the corporation changed its name since it last filed a return, check the box for "Name change." Generally, a corporation must also have amended its articles of incorporation and filed the amendment with the state in which it is incorporated.
- If the corporation has changed its address since it last filed a return, (including a change to an "in care of" address), check the box for "Address change." If a change in address occurs after the return is filed, use Form 8822, Change of Address, to notify the IRS of the new address.
- If this amends a previously filed return, check the box for "Amended return." If Schedules K-1 are also being amended, check the "Amended K-1" box on each Schedule K-1.
- If the corporation has terminated or revoked its S election, check the "S election termination or revocation" box.

INCOME

Caution. Report only trade or business activity income on lines 1a through 5. Do not report rental activity income or portfolio income on these lines. See Passive Activity Limitations, earlier, for definitions of rental income and portfolio income. Rental activity income and portfolio income are reported on Schedules K and K-1. Rental real estate activities are also reported on Form 8825.

Tax-exempt income. Do not include any tax-exempt income on lines 1a through 5. A corporation that receives any exempt income other than interest, or holds any property or engages in an activity that produces exempt income, reports this income on line 16b of Schedule K and in box 16, code B, of Schedule K-1.

Report tax-exempt interest income, including exempt-interest dividends received as a shareholder in a mutual fund or other regulated investment company, on line 16a of Schedule K and in box 16, code A, of Schedule K-1.

See *Deductions* for information on how to report expenses related to tax-exempt income.

Election to defer income from canceled debt. Do not include any cancellation of debt (COD) income that is deferred under section 108(i) on lines 1a through 5. Report deferred COD income that is required to be included in income in the current year under section 108(i) on line 10 of Schedule K and in box 10 of Schedule K-1 using code E (other income). See *Other income (loss) (code E)*, later, for details.

If the corporation elects under section 108(i) to defer COD income, the exclusions for COD income under section 108(a)(1)(A), (B), (C), and (D) do not apply to the deferred COD income for the tax year of the election or any later year.

A corporation that receives a Schedule K-1 from a partnership containing information relating to a section 108(i) election must report on the Schedules K-1 to its shareholders certain information relative to the section 108(i) election.

Cancelled debt exclusion. If the corporation has had debt discharged resulting from a title 11 bankruptcy proceeding or while insolvent, see Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), and Pub. 908, Bankruptcy Tax Guide.

Line 1. Gross Receipts or Sales

Enter gross receipts or sales from all trade or business operations except those that must be reported on lines 4 and 5.

Advance payments. In general, advance payments are reported in the year of receipt. To report income from long-term contracts, see section 460.

Installment sales. Generally, the installment method cannot be used for dealer dispositions of property. A “dealer disposition” is any disposition of (a) personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan or (b) real property held for sale to customers in the ordinary course of the taxpayer’s trade or business.

These restrictions on using the installment method do not apply to dispositions of property used or produced in a farming business or sales of timeshares and residential lots for which the corporation elects to pay interest under section 453(l)(3).

For sales of timeshares and residential lots reported under the installment method, each shareholder’s income tax is increased by the shareholder’s pro rata share of the interest payable under section 453(l)(3).

Enter on line 1a the gross profit on collections from installment sales for any of the following:

- Dealer dispositions of property before March 1, 1986.
- Dispositions of property used or produced in the trade or business of farming.
- Certain dispositions of timeshares and residential lots reported under the installment method.

Attach a statement showing the following information for the current and the 3 preceding years:

- Gross sales.
- Cost of goods sold.
- Gross profits.
- Percentage of gross profits to gross sales.
- Amount collected.
- Gross profit on the amount collected.

Line 2. Cost of Goods Sold

See the instructions for Schedule A.

Line 4. Net Gain (Loss) From Form 4797

Caution. Include only ordinary gains or losses from the sale, exchange, or involuntary conversion of assets used in a trade or business activity. Ordinary gains or losses from the sale, exchange, or involuntary conversion of rental activity assets are reported separately on line 19 of Form 8825 or line 3 of Schedule K and box 3 of Schedule K-1, generally as a part of the net income (loss) from the rental activity.

A corporation that is a partner in a partnership must include on Form 4797, Sales of Business Property, its share of ordinary gains (losses) from sales, exchanges, or involuntary or compulsory conversions (other than casualties or thefts) of the partnership's trade or business assets.

Corporations should not use Form 4797 to report the sale or other disposition of property if a section 179 expense deduction was previously passed through to any of its shareholders for that property. Instead, report it in box 17 of Schedule K-1 using code K. See the instructions for *Dispositions of property with section 179 deductions (code K)*, for details.

Line 5. Other Income (Loss)

Enter any other trade or business income (loss) that is not included on lines 1a through 4. List the type and amount of income on an attached statement.

Examples of other income include the following:

- Interest income derived in the ordinary course of the corporation's trade or business, such as interest charged on receivable balances.
- Recoveries of bad debts deducted in prior years under the specific charge-off method.
- Taxable income from insurance proceeds.
- The amount included in income from line 7 of Form 6478, Alcohol and Cellulosic Biofuel Fuels Credit.
- The amount included in income from line 8 of Form 8864, Biodiesel and Renewable Diesel Fuels Credit.
- The recapture amount under section 280F if the business use of listed property drops to 50% or less. To figure the recapture amount, the corporation must complete Part IV of Form 4797.
- Any recapture amount under section 179A for certain clean-fuel vehicle property (or clean-fuel vehicle refueling property) that ceases to qualify.
- All section 481 income adjustments resulting from changes in accounting methods. Show the computation of the section 481 adjustments on an attached statement.
- Part or all of the proceeds received from certain corporate-owned life insurance contracts issued after August 17, 2006.

Do not include items requiring separate computations by shareholders that must be reported on Schedules K and K-1.

Ordinary Income (Loss) From a Partnership, Estate, or Trust

Enter the ordinary income (loss) shown on Schedule K-1 (Form 1065), or Schedule K-1 (Form 1041), or from a foreign partnership, estate, or trust. Show the partnership's, estate's, or trust's name, address, and EIN (if any) on a separate statement attached to this return. If the amount entered is from more than one source, identify the amount from each source.

Do not include portfolio income or rental activity income (loss) from a partnership, estate, or trust on this line. Instead, report these amounts on the applicable lines or boxes of Schedules K and K-1, or on line 20a of Form 8825 if the amount is from a rental real estate activity.

Ordinary income or loss from a partnership that is a publicly traded partnership is not reported on this line. Instead, report the amount separately on line 10 of Schedule K and in box 10, code E, of Schedule K-1.

Treat shares of other items separately reported on Schedule K-1 issued by the other entity as if the items were directly realized or incurred by this corporation.

If there is a loss from a partnership, the amount of the loss that may be claimed is subject to the at-risk and basis limitations as appropriate.

If the tax year of the S corporation does not coincide with the tax year of the partnership, estate, or trust, include the ordinary income (loss) from the other entity in the tax year in which the other entity's tax year ends.

DEDUCTIONS

Caution. Report only trade or business activity deductions on lines 7 through 19.

Do not report the following expenses on lines 7 through 19.

- Rental activity expenses. Report these expenses on Form 8825 or line 3b of Schedule K.
- Deductions allocable to portfolio income. Report these deductions on line 12d of Schedule K and in box 12 of Schedule K-1 using code I, K, or L.
- Nondeductible expenses (for example, expenses connected with the production of tax-exempt income). Report nondeductible expenses on line 16c of Schedule K and in box 16 of Schedule K-1 using code C.
- Qualified expenditures to which an election under section 59(e) may apply. The instructions for line 12c of Schedule K and for Schedule K-1, box 12, code J explain how to report these amounts.
- Items the corporation must state separately that require separate computations by the shareholders. Examples include expenses incurred for the production of income instead of in a trade or business, charitable contributions, foreign taxes paid or accrued, intangible drilling and development costs, soil and water conservation expenditures, amortizable basis of reforestation expenditures, and exploration expenditures. The pro rata shares of these expenses are reported separately to each shareholder on Schedule K-1.

Limitations on Deductions

Section 263A uniform capitalization rules. The uniform capitalization rules of section 263A require corporations to capitalize or include in inventory certain costs incurred in connection with the following.

- The production of real and tangible personal property held in inventory or held for sale in the ordinary course of business.
- Real property or personal property (tangible and intangible) acquired for resale.
- The production of real property and tangible personal property by a corporation for use in its trade or business or in an activity engaged in for profit.

Tangible personal property produced by a corporation includes a film, sound recording, videotape, book or similar property.

The costs required to be capitalized under section 263A are not deductible until the property to which the costs relate is sold, used, or otherwise disposed of by the corporation.

Exceptions. Section 263A does not apply to:

- Inventoriable items accounted for in the same manner as materials and supplies that are not incidental.
- Personal property acquired for resale if the taxpayer's average annual gross receipts for the 3 prior tax years are \$10 million or less.
- Timber.
- Most property produced under a long-term contract.
- Certain property produced in a farming business. See *Special rules for certain corporations engaged in farming* below.
- Geological and geophysical costs amortized under section 167(h).
- Capital costs incurred to comply with EPA sulfur regulations.

The corporation must report the following costs separately to the shareholders for purposes of determinations under section 59(e):

- Research and experimental costs under section 174.
- Intangible drilling costs for oil, gas, and geothermal property.
- Mining exploration and development costs.

Indirect costs. Corporations subject to the uniform capitalization rules are required to capitalize not only direct costs but an allocable portion of most indirect costs (including taxes) that benefit the assets produced or acquired for resale or are incurred by reason of the performance of production or resale activities.

For inventory, some of the indirect costs that must be capitalized are:

- Administration expenses;
- Taxes;
- Depreciation;
- Insurance;
- Compensation paid to officers attributable to services;
- Rework labor; and

- Contributions to pension, stock bonus, and certain profit-sharing, annuity, or deferred compensation plans.

Regulations section 1.263A-1(e)(3) specifies other indirect costs that relate to production or resale activities that must be capitalized and those that may be currently deductible.

Interest expense paid or incurred during the production period of designated property must be capitalized and is governed by special rules.

Special rules for certain corporations engaged in farming. For S corporations not required to use the accrual method of accounting, the rules of section 263A do not apply to expenses of raising any:

- Animal or
- Plant that has a preproductive period of 2 years or less.

Shareholders of S corporations not required to use the accrual method of accounting may elect to currently deduct the preproductive period expenses of certain plants that have a preproductive period of more than 2 years. Because each shareholder makes the election to deduct these expenses, the corporation should not capitalize them. Instead, the corporation should report the expenses separately on line 12d of Schedule K and report each shareholder's pro rata share in box 12, code M, of Schedule K-1.

Transactions between related taxpayers. Generally, an accrual basis S corporation can only deduct business expenses and interest owed to a related party (including any shareholder) only in the tax year of the corporation that includes the day on which the payment is includible in the income of the related party.

Section 291 limitations. If the S corporation was a C corporation for any of the 3 immediately preceding years, the corporation may be required to adjust deductions allowed to the corporation for depletion of iron ore and coal, and the amortizable basis of pollution control facilities.

Business start-up and organizational costs. A corporation can elect to deduct up to \$5,000 of business start-up and up to \$5,000 of organizational costs paid or incurred after October 22, 2004. Any remaining costs must be amortized. The \$5,000 deduction is reduced (but not below zero) by the amount the total costs exceed \$50,000. If the total costs are \$55,000 or more, the deduction is reduced to zero.

Special rule for 2010 start-up costs. For a tax year beginning in 2010, a corporation can elect to deduct up to \$10,000 of business start-up costs paid or incurred after December 31, 2009. The \$10,000 deduction is reduced (but not below zero) by the amount such start-up costs exceed \$60,000. Any remaining costs must be amortized. See section 195(b)(3).

Time for making an election. The corporation generally elects to deduct start-up or organizational costs by claiming the deduction on its income tax return filed by the due date (including extensions) for the tax year in which the active trade or business begins. However, for start-up or organizational costs paid or incurred before September 9, 2008, the corporation may be required to attach a statement to its return to elect to deduct such costs. See Temporary Regulations sections 1.195-1T and 1.248-1T for details.

If the corporation timely filed its return for the year without making an election, it can still make an election by filing an amended return within 6 months of the due date of the return (excluding extensions). Clearly indicate the election on the amended return and write "Filed pursuant to section 301.9100-2" at the top of the amended return. File the amended return at the same address the corporation filed its original return. The election applies when figuring taxable income for the current tax year and all subsequent years.

Note. The corporation can choose to forgo the elections above by clearly electing to capitalize its start-up or organizational costs on an income tax return filed by the due date (including extensions) for the tax year in which the active trade or business begins.

Report the deductible amount of start-up and organizational cost and any amortization on line 19. For amortization that begins during the 2010 tax year, complete and attach Form 4562. See the instructions for Form 4562.

Reducing certain expenses for which credits are allowable. For each credit listed below, the corporation must reduce the otherwise allowable deduction for expenses used to figure the credit.

- Form 5884, Work Opportunity Credit.
- Form 6765, Credit for Increasing Research Activities.
- Form 8820, Orphan Drug Credit.
- Form 8826, Disabled Access Credit.
- Form 8844, Empowerment Zone and Renewal Community Employment Credit.
- Form 8845, Indian Employment Credit.
- Form 8846, Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips.
- Form 8881, Credit for Small Employer Pension Plan Startup Costs.
- Form 8882, Credit for Employer-Provided Childcare Facilities and Services.
- Form 8896, Low Sulfur Diesel Fuel Production Credit.
- Form 8923, Mine Rescue Team Training Credit.
- Form 8931, Agricultural Chemicals Security Credit.
- Form 8932, Credit for Employer Differential Wage Payments.
- Form 8941, Credit for Small Employer Health Insurance Premiums.

If the corporation has any of these credits, figure each current year credit before figuring the deduction for expenses on which the credit is based. If the corporation capitalized any costs on which it figured the credit, it may need to reduce the amount capitalized by the credit attributable to these costs.

If the corporation has qualified investment taken into account in determining the qualifying therapeutic discovery project credit or grant, it may need to reduce the otherwise allowable deductions for such qualified investments. See the instructions for the form used to figure the credit.

Line 7. Compensation of Officers and Line 8. Salaries and Wages

Caution. *Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation.*

Enter on line 7 the total compensation of all officers paid or incurred in the trade or business activities of the corporation. The corporation determines who is an officer under the laws of the state where it is incorporated.

Enter on line 8 the amount of salaries and wages paid or incurred to employees (other than officers) during the tax year.

If the corporation claims a credit for any wages paid or incurred, it may need to reduce the amounts on lines 7 and 8. See *Reducing certain expenses for which credits are allowable* earlier for details.

Do not include salaries and wages deductible elsewhere on the return, such as amounts included in cost of goods sold, elective contributions to a section 401(k) cash or deferred arrangement, or amounts contributed under a salary SEP agreement or a SIMPLE IRA plan.

Include fringe benefit expenditures made on behalf of officers and employees owning more than 2% of the corporation's stock. Also report these fringe benefits as wages in box 1 of Form W-2. Do not include amounts paid or incurred for fringe benefits of officers and employees owning 2% or less of the corporation's stock. These amounts are reported on line 18. See the instructions for that line for information on the types of expenditures that are treated as fringe benefits and for the stock ownership rules.

Report amounts paid for health insurance coverage for a more than 2% shareholder (including that shareholder's spouse, dependents, and any children under age 27 who are not dependents) as an information item in box 14 of that shareholder's Form W-2. A more-than-2% shareholder may be allowed to deduct such amounts on Form 1040, line 29.

If a shareholder or a member of the family of one or more shareholders of the corporation renders services or furnishes capital to the corporation for which reasonable compensation is not paid, the IRS may make adjustments in the items taken into account by such individuals to reflect the value of such services or capital.

Line 9. Repairs and Maintenance

Enter the costs of incidental repairs and maintenance, such as labor and supplies, that do not add to the value of the property or appreciably prolong its life. The corporation may deduct these repairs only to the extent they relate to a trade or business activity and are not claimed elsewhere on the return. New buildings, machinery, or permanent improvements that increase the value of the property are not deductible. They must be depreciated or amortized.

Line 10. Bad Debts

Enter the total debts that became worthless in whole or in part during the year, but only to the extent such debts relate to a trade or business activity. Report deductible nonbusiness bad debts as a short-term capital loss on Schedule D (Form 1120S). A cash method taxpayer may not claim a bad debt deduction unless the amount was previously included in income.

Line 11. Rents

Enter rent paid on business property used in a trade or business activity. Do not deduct rent for a dwelling unit occupied by any shareholder for personal use.

If the corporation rented or leased a vehicle, enter the total annual rent or lease expense paid or incurred in the trade or business activities of the corporation. Also complete Part V of Form 4562, Depreciation and Amortization. If the corporation leased a vehicle for a term of 30 days or more, the deduction for vehicle lease expense may have to be reduced by an amount called the inclusion amount. The corporation may have an inclusion amount if:

The lease term began:	And the vehicle's FMV on the first day of the lease exceeded:
After 12/31/07 but before 1/1/11	\$18,500
After 12/31/06 but before 1/1/08	\$15,500
After 12/31/04 but before 1/1/07	\$15,200
After 12/31/03 but before 1/1/05	\$17,500

If lease term began before January 1, 2004, see Pub. 463, Travel, Entertainment, Gift, and Car Expenses to find out if the corporation has an inclusion amount

Line 12. Taxes and Licenses

Enter taxes and licenses paid or incurred in the trade or business activities of the corporation, unless they are reflected in cost of goods sold. Federal import duties and federal excise and stamp taxes are deductible only if paid or incurred in carrying on the trade or business of the corporation.

Do not deduct the following taxes on line 12:

- Federal income taxes (except for the portion of built-in gains tax allocable to ordinary income), or taxes reported elsewhere on the return.
- Section 901 foreign taxes. Report these taxes separately on line 14I of Schedule K and in box 14 of Schedule K-1, using codes L and M.
- Taxes allocable to a rental activity. Taxes allocable to a rental real estate activity are reported on Form 8825. Taxes allocable to a rental activity other than a rental real estate activity are reported on line 3b of Schedule K.
- Taxes allocable to portfolio income. Report these taxes separately on line 12d of Schedule K and in box 12, code K, of Schedule K-1.
- Taxes paid or incurred for the production or collection of income, or for the management, conservation, or maintenance of property held to produce income. Report these taxes separately on line 12d of Schedule K and in box 12, code S, of Schedule K-1.

See section 263A(a) for information on capitalization of allocable costs (including taxes) for any property.

- Taxes not imposed on the corporation.

- Taxes, including state or local sales taxes, that are paid or incurred in connection with an acquisition or disposition of property (these taxes must be treated as a part of the cost of the acquired property or, in the case of a disposition, as a reduction in the amount realized on the disposition).
- Taxes assessed against local benefits that increase the value of the property assessed (such as for paving, etc.).

See section 164(d) for apportionment of taxes on real property between seller and purchaser.

Line 13. Interest

Include only interest incurred in the trade or business activities of the corporation that is not claimed elsewhere on the return.

Do not include interest expense:

- On debt used to purchase rental property or debt used in a rental activity. Interest allocable to a rental real estate activity is reported on Form 8825 and is used in arriving at net income (loss) from rental real estate activities on line 2 of Schedule K or box 2 of Schedule K-1. Interest allocable to a rental activity other than a rental real estate activity is included on line 3b of Schedule K and is used in arriving at net income (loss) from a rental activity (other than a rental real estate activity). This net amount is reported on line 3c of Schedule K and in box 3 of Schedule K-1.
- On debt used to buy property held for investment. Do not include interest expense that is clearly and directly allocable to interest, dividend, royalty, or annuity income not derived in the ordinary course of a trade or business. Interest paid or incurred on debt used to purchase or carry investment property is reported on line 12b of Schedule K and in box 12 of Schedule K-1 using code H. See the instructions for line 12b of Schedule K, for box 12, code H of Schedule K-1, and Form 4952, Investment Interest Expense Deduction, for more information on investment property.
- On debt proceeds allocated to distributions made to shareholders during the tax year. Instead, report such interest on line 12d of Schedule K and in box 12 of Schedule K-1 using code S. To determine the amount to allocate to distributions to shareholders, see Notice 89-35, 1989-1 C.B. 675.
- On debt required to be allocated to the production of designated property. Designated property includes real property, personal property that has a class life of 20 years or more, and other tangible property requiring more than 2 years (1 year in the case of property with a cost of more than \$1 million) to produce or construct. Interest allocable to designated property produced by a corporation for its own use or for sale must be capitalized. In addition, a corporation must also capitalize any interest on debt allocable to an asset used to produce designated property. A shareholder may have to capitalize interest that the shareholder incurs during the tax year for the production expenditures of the S corporation. Similarly, interest incurred by an S corporation may have to be capitalized by a shareholder for the shareholder's own production expenditures. The information required by the shareholder to properly capitalize interest for this purpose must be provided by the corporation on an attachment for box 17 of Schedule K-1 using code P. See section 263A(f) and Regulations sections 1.263A-8 through 1.263A-15.

Special rules apply to:

- Allocating interest expense among activities so that the limitations on passive activity losses, investment interest, and personal interest can be properly figured. Generally, interest expense is allocated in the same manner as debt is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. Temporary Regulations section 1.163-8T gives rules for tracing debt proceeds to expenditures.
- Prepaid interest, which generally can only be deducted over the period to which the prepayment applies. See section 461(g) for details.
- Interest which is allocable to unborrowed policy cash values of life insurance, endowment, or annuity contracts issued after June 8, 1997. See section 264(f). Attach a statement showing the computation of the deduction.

Line 14. Depreciation

Enter the depreciation claimed on assets used in a trade or business activity less any depreciation reported elsewhere on the return. See the Instructions for Form 4562 or Pub. 946, How To Depreciate Property, to figure the amount of depreciation to enter on this line.

Complete and attach Form 4562 only if the corporation placed property in service during the tax year, or claims depreciation on any car or other listed property.

Do not include any section 179 expense deduction on this line. This amount is not deductible by the corporation. Instead, it is reported and passed through to the shareholders in box 11 of Schedule K-1.

Line 15. Depletion

If the corporation claims a deduction for timber depletion, complete and attach Form T, Forest Activities Schedule.

Caution. Do not deduct depletion for oil and gas properties. Each shareholder figures depletion on oil and gas properties. See the instructions for Schedule K-1, box 17, code R, for information on oil and gas depletion that must be supplied to the shareholders by the corporation.

Line 17. Pension, Profit-Sharing, etc., Plans

Enter the deductible contributions not claimed elsewhere on the return made by the corporation for its employees under a qualified pension, profit-sharing, annuity, or simplified employee pension (SEP) or SIMPLE plan, or any other deferred compensation plan.

If the corporation contributes to an individual retirement arrangement (IRA) for employees, include the contribution in salaries and wages on page 1, line 8, or Schedule A, line 3, and not on line 17.

Employers who maintain a pension, profit-sharing, or other funded deferred compensation plan, whether or not qualified under the Internal Revenue Code and whether or not a deduction is claimed for the current tax year, generally must file the applicable form listed below.

- Form 5500, Annual Return/Report of Employee Benefit Plan.
- Form 5500-SF, Short Form Annual Return/Report of Small Employee Benefit Plan (generally filed instead of Form 5500 if there are under 100 participants at the beginning of the plan year).
- Form 5500-EZ, Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan. File this form for a plan that only covers the owner (or the owner and his or her spouse) but only if the owner (or the owner and his or her spouse) owns the entire business.

Note. Form 5500 and Form 5500-SF must be filed electronically under the computerized ERISA Filing Acceptance System (EFAST2). For more information, see the EFAST2 website at www.efast.dol.gov.

There are penalties for failure to file these forms on time and for overstating the pension plan deduction.

Line 18. Employee Benefit Programs

Enter amounts for fringe benefits paid or incurred on behalf of employees owning 2% or less of the corporation's stock. These fringe benefits include (a) employer contributions to certain accident and health plans, (b) the cost of up to \$50,000 of group-term life insurance on an employee's life, and (c) meals and lodging furnished for the employer's convenience.

Do not deduct amounts that are an incidental part of a pension, profit-sharing, etc., plan included on line 17 or amounts reported elsewhere on the return.

Report amounts paid on behalf of more than 2% shareholders on line 7 or 8, whichever applies. A shareholder is considered to own more than 2% of the corporation's stock if that person owns on any day during the tax year more than 2% of the outstanding stock of the corporation or stock possessing more than 2% of the combined voting power of all stock of the corporation.

Line 19. Other Deductions

Enter the total of all allowable trade or business deductions that are not deductible elsewhere on page 1 of Form 1120S. Attach a schedule listing by type and amount each deduction included on this line.

Examples of other deductions include:

- Amortization. See Part VI Form 4562.
- Certain business start-up and organizational costs.
- Insurance premiums.
- Legal and professional fees.
- Supplies used and consumed in the business.

- Travel, meal, and entertainment expenses. Special rules apply.
- Utilities.
- Deduction for certain energy efficient commercial building property placed in service during the tax year. See section 179D.
- Any negative net section 481(a) adjustment.

Do not deduct the following on line 19.

- Items that must be reported separately on Schedules K and K-1.
- Fines or penalties paid to a government for violating any law. Report these expenses on Schedule K, line 16c.
- Expenses allocable to tax-exempt income. Report these expenses on Schedule K, line 16c.

Special Rules

Commercial revitalization deduction. If the corporation constructs, purchases, or substantially rehabilitates a qualified building in a renewal community, it may qualify for a deduction of either (a) 50% of qualified capital expenditures in the year the building is placed in service or (b) amortization of 100% of the qualified capital expenditures over a 120-month period beginning with the month the building is placed in service. If the corporation elects to amortize these expenditures, it must complete and attach Form 4562. To qualify, the building must be nonresidential (as defined in section 168(e)(2)) and placed in service by the corporation. The corporation must be the original user of the building unless it is substantially rehabilitated. The amount of the qualified expenditures cannot exceed the lesser of \$10 million or the amount allocated to the building by the commercial revitalization agency of the state in which the building is located. Any remaining expenditures are depreciated over the regular depreciation recovery period.

Note. The commercial revitalization deduction is not available for buildings placed in service after 2009.

Rental real estate. Do not report this deduction on line 19 if the building is placed in service as rental real estate. A commercial revitalization deduction for rental real estate is not deducted by the corporation but is passed through to the shareholders in box 12 of Schedule K-1 using code N.

Travel, meals, and entertainment. Subject to limitations and restrictions discussed below, a corporation can deduct ordinary and necessary travel, meals, and entertainment expenses paid or incurred in its trade or business. Also, special rules apply to deductions for gifts, skybox rentals, luxury water travel, convention expenses, and entertainment tickets.

Travel. The corporation cannot deduct travel expenses of any individual accompanying a corporate officer or employee, including a spouse or dependent of the officer or employee, unless:

- That individual is an employee of the corporation, and
- His or her travel is for a bona fide business purpose and would otherwise be deductible by that individual.

Meals and entertainment. Generally, the corporation can deduct only 50% of the amount otherwise allowable for meals and entertainment expenses paid or incurred in its trade or business. In addition (subject to exceptions under section 274(k)(2)):

- Meals must not be lavish or extravagant;
- A bona fide business discussion must occur during, immediately before, or immediately after the meal; and
- An employee of the corporation must be present at the meal.

See section 274(n)(3) for a special rule that applies to expenses for meals consumed by individuals subject to the hours of service limits of the Department of Transportation.

Membership dues. The corporation may deduct amounts paid or incurred for membership dues in civic or public service organizations, professional organizations (such as bar and medical associations), business leagues, trade associations, chambers of commerce, boards of trade, and real estate boards. However, no deduction is allowed if a principal purpose of the organization is to entertain, or provide entertainment facilities for, members or their guests. In addition, corporations may not deduct membership dues in any club organized for business, pleasure, recreation, or other social purpose. This includes country clubs, golf and athletic clubs, airline and hotel clubs, and clubs operated to provide meals under conditions favorable to business discussion.

Entertainment facilities. Generally, the corporation cannot deduct an expense paid or incurred for a facility (such as a yacht or hunting lodge) used for an activity usually considered entertainment, amusement, or recreation.

Amounts treated as compensation. Generally, the corporation may be able to deduct otherwise nondeductible meals, travel, and entertainment expenses if the amounts are treated as compensation to the recipient and reported on Form W-2 for an employee or on Form 1099-MISC for an independent contractor.

However, if the recipient is an officer, director, or beneficial owner (directly or indirectly) of more than 10% of the corporation's stock, the deductible expense is limited. See section 274(e)(2).

Lobbying expenses. Generally, lobbying expenses are not deductible. Report nondeductible expense on Schedule K, line 16c. These expenses include:

- Amounts paid or incurred in connection with influencing federal or state legislation (but not local legislation); or
- Amounts paid or incurred in connection with any communication with certain federal executive branch officials in an attempt to influence the official actions or positions of the officials. See Regulations section 1.162-29 for the definition of "influencing legislation."

Dues and other similar amounts paid to certain tax-exempt organizations may not be deductible. See section 162(e)(3). If certain in-house lobbying expenditures do not exceed \$2,000, they are deductible. For information on contributions to charitable organizations that conduct lobbying activities, see section 170(f)(9).

Certain corporations engaged in farming. Section 464(f) limits the deduction for certain expenditures of S corporations engaged in farming if they use the cash method of accounting, and their prepaid farm supplies are more than 50% of other deductible farming expenses.

Prepaid farm supplies include expenses for feed, seed, fertilizer, and similar farm supplies not used or consumed during the year. They also include the cost of poultry that would be allowable as a deduction in a later tax year if the corporation were to (a) capitalize the cost of poultry bought for use in its farm business and deduct it ratably over the lesser of 12 months or the useful life of the poultry and (b) deduct the cost of poultry bought for resale in the year it sells or otherwise disposes of it.

If the limit applies, the corporation can deduct prepaid farm supplies that do not exceed 50% of its other deductible farm expenses in the year of payment. The excess is deductible only in the year the corporation uses or consumes the supplies (other than poultry, which is deductible as explained above).

Reforestation expenditures. If the corporation made an election to deduct a portion of its reforestation expenditures on line 12d of Schedule K, it must amortize over an 84-month period the portion of these expenditures in excess of the amount deducted on Schedule K (see section 194). Deduct on line 19 only the amortization of these excess reforestation expenditures. See *Reforestation expense deduction (code O)*.

Caution. Do not deduct amortization of reforestation expenditures paid or incurred before October 23, 2004. If the corporation elected to amortize these expenditures, report the amortizable basis on line 17d of Schedule K. See *Amortization of reforestation costs (code S)*.

Line 21. Ordinary Business Income (Loss)

Enter this income or loss on line 1 of Schedule K. Line 21 income is **not** used in figuring the excess net passive income or built-in gains taxes. See the instructions for line 22a for figuring taxable income for purposes of these taxes.

TAX AND PAYMENTS

Line 22a. Excess Net Passive Income and LIFO Recapture Tax

These taxes can apply if the corporation was previously a C corporation or if the corporation engaged in a tax-free reorganization with a C corporation.

Excess net passive income tax. If the corporation has accumulated earnings and profits (AE&P) at the close of its tax year, has passive investment income for the tax year that is in excess of 25% of gross receipts, and has taxable income at year-end, the corporation must pay a tax on the excess net passive income. Complete lines 1 through 3 and line 9 of the worksheet later to make this determination. If line 2 is greater than line 3 and the corporation has taxable income (see instructions for line 9 of worksheet), it must pay the tax. Complete a separate schedule using the format of lines 1 through 11 of the worksheet to figure the tax. Enter the tax on line 22a, page 1, Form 1120S, and attach the computation schedule to Form 1120S.

Reduce each item of passive income passed through to shareholders by its portion of any excess net passive income tax reported on line 22a. See section 1366(f)(3).

LIFO recapture tax. The corporation may be liable for the additional tax due to LIFO recapture under Regulations section 1.1363-2 if:

- The corporation used the LIFO inventory pricing method for its last tax year as a C corporation, or
- A C corporation transferred LIFO inventory to the corporation in a nonrecognition transaction in which those assets were transferred basis property.

The additional tax due to LIFO recapture is figured for the corporation's last tax year as a C corporation or for the tax year of the transfer, whichever applies. See the instructions for Forms 1120 to figure the tax.

The tax is paid in four equal installments. The C corporation must pay the first installment by the due date (not including extensions) of Form 1120 for the corporation's last tax year as a C corporation or for the tax year of the transfer, whichever applies. The S corporation must pay each of the remaining installments by the due date (not including extensions) of Form 1120S for the 3 succeeding tax years. Include this year's installment in the total amount to be entered on line 22a. To the left of the total on line 22a, enter the installment amount and "LIFO tax."

Excess Net Passive Income Tax Worksheet for line 22a

- | | |
|--|---------|
| 1. Enter gross receipts for the tax year (see section 1362(d)(3)(B) for gross receipts from the sale of capital assets)* | _____ |
| 2. Enter passive investment income as defined in section 1362(d)(3)(C)* | _____ |
| 3. Enter 25% of line 1 (If line 2 is less than line 3, stop here. You are not liable for this tax.) | _____ |
| 4. Excessive passive investment income – Subtract line 3 from line 2 | _____ |
| 5. Enter deductions directly connected with the production of income on line 2 (see section 1375(b)(2))* | _____ |
| 6. Net passive income – Subtract line 5 from line 2 | _____ |
| 7. Divide amount on line 4 by amount on line 2 | _____ % |
| 8. Excess net passive income – Multiply line 6 by line 7 | _____ |
| 9. Enter taxable income (see instructions for taxable income below) | _____ |
| 10. Enter smaller of line 8 or line 9 | _____ |
| 11. Excess net passive income tax – Enter 35% of line 10. Enter here and on line 22a, page 1, Form 1120S | _____ |

*Income and deductions on lines 1, 2, and 5 are from total operations for the tax year. This includes applicable income and expenses from page 1, Form 1120S, as well as those reported separately on Schedule K. See section 1375(b)(4) for an exception regarding lines 2 and 5.

Line 9 of Worksheet – Taxable income

Line 9 taxable income is defined in Regulations section 1.1374-1A(d). Figure this income by completing lines 1 through 28 of Form 1120, U.S. Corporation Income Tax Return. Include the Form 1120 computation with the worksheet computation you attach to Form 1120S. You do not have to attach the schedules, etc. called for on Form 1120. However, you may want to complete certain Form 1120 schedules, such as Schedule D (Form 1120) if you have capital gains or losses.

Line 22b. Tax From Schedule D (Form 1120S)

Enter the built-in gains tax from line 21 of Part III of Schedule D. See the instructions for Part III of Schedule D to determine if the corporation is liable for the tax.

Line 22c

Include the following in the total for line 22c.

Investment credit recapture tax. The corporation is liable for investment credit recapture attributable to credits allowed for tax years for which the corporation was not an S corporation. Figure the corporation's investment credit recapture tax by completing Form 4255, Recapture of Investment Credit.

To the left of the line 22c total, enter the amount of recapture tax and "Tax From Form 4255." Attach Form 4255 to Form 1120S.

Interest due under the look-back method for completed long-term contracts. If the corporation owes this interest, attach Form 8697. To the left of the total on line 22c, enter the amount owed and "From Form 8697."

Interest due under the look-back method for property depreciated under the income forecast method. If the corporation owes this interest, attach Form 8866. To the left of the total on line 22c, enter the amount owed and "From Form 8866."

Line 23d

If the corporation is the beneficiary of a trust, and the trust makes a section 643(g) election to credit its estimated tax payments to its beneficiaries, include the corporation's share of the payment in the total for line 23d. Enter "T" and the amount on the dotted line to the left of the entry space.

Line 24. Estimated Tax Penalty

If Form 2220 is attached, check the box on line 24 and enter the amount of any penalty on this line.

Line 27

Direct Deposit of Refund. If the corporation wants its refund directly deposited into its checking or savings account at any U.S. bank or other financial institution instead of having a check sent to the corporation, complete Form 8050 and attach it to the corporation's return. However, the corporation cannot have its refund from an amended return directly deposited.

Schedule A. Cost of Goods Sold

Generally, inventories are required at the beginning and end of each tax year if the production, purchase, or sale of merchandise is an income-producing factor.

However, if the corporation is a qualifying taxpayer or a qualifying small business taxpayer, it can adopt or change its accounting method to account for inventoriable items in the same manner as materials and supplies that are not incidental unless its business is a tax shelter as defined in section 448(d)(3).

A qualifying taxpayer is a taxpayer that, for each prior tax year ending after December 16, 1998, has average annual gross receipts of \$1 million or less for the 3-tax-year period ending with that prior tax year.

A qualifying small business taxpayer is a taxpayer (a) that, for each prior tax year ending on or after December 31, 2000, has average annual gross receipts of \$10 million or less for the 3-tax-year period ending with that prior tax year and (b) whose principal business activity is not an ineligible activity.

Under this accounting method, inventory costs for raw materials purchased for use in producing finished goods and merchandise purchased for resale are deductible in the year the finished goods or merchandise are sold (but not before the year the corporation paid for the raw materials or merchandise, if it is also using the cash method). For additional guidance on this method of accounting for inventoriable items, see Pub. 538 and the Instructions for Form 3115.

Enter amounts paid for all raw materials and merchandise during the tax year on line 2. The amount the corporation can deduct for the tax year is figured on line 8.

All filers that have not elected to treat inventoriable items as materials and supplies that are not incidental should see *section 263A uniform capitalization rules* before completing Schedule A.

Line 1. Inventory at Beginning of Year

If the corporation is changing its method of accounting for the current tax year, it must refigure last year's closing inventory using its new method of accounting and enter the result on line 1. If there is a difference between last year's closing inventory and the refigured amount, attach an explanation and take it into account when figuring the corporation's section 481(a) adjustment.

Line 4. Additional Section 263A Costs

An entry is required on this line only for corporations that have elected a simplified method of accounting.

For corporations that have elected the simplified production method, additional section 263A costs are generally those costs, other than interest, that were not capitalized under the corporation's method of accounting immediately prior to the effective date of section 263A but are now required to be capitalized under section 263A.

For corporations that have elected the simplified resale method, additional section 263A costs are generally those costs incurred with respect to the following categories.

- Off-site storage or warehousing.
- Purchasing.
- Handling, such as processing, assembly, repackaging, and transporting.
- General and administrative costs (mixed service costs).

Enter on line 4 the balance of section 263A costs paid or incurred during the tax year not includible on lines 2, 3, and 5.

Line 5. Other Costs

Enter on line 5 any other costs paid or incurred during the tax year not entered on lines 2 through 4.

Line 7. Inventory at End of Year

See Regulations sections 1.263A-1 through 1.263A-3 for details on figuring the amount of additional section 263A costs to be included in ending inventory. If the corporation accounts for inventoriable items in the same manner as materials and supplies that are not incidental, enter on line 7 the portion of its raw materials and merchandise purchased for resale that is included on line 6 and was not sold during the year.

Lines 9a Through 9f. Inventory Valuation Methods

Inventories can be valued at:

- Cost;
- Cost or market value (whichever is lower); or
- Any other method approved by the IRS that conforms to the requirements of the applicable regulations.

However, if the corporation is using the cash method of accounting, it is required to use cost.

Generally, a rolling average method that is used to value inventories for financial accounting purposes does not clearly reflect income for federal income tax purposes. However, if a corporation uses the average cost method for financial accounting purposes, there are two safe harbors under which this method will be deemed to clearly reflect income for federal income tax purposes.

Corporations that use erroneous valuation methods must change to a method permitted for federal income tax purposes. To make this change, use Form 3115.

On line 9a, check the method(s) used for valuing inventories. Under “lower of cost or market,” market (for normal goods) means the current bid price prevailing on the inventory valuation date for the particular merchandise in the volume usually purchased by the taxpayer. For a manufacturer, market applies to the basic elements of cost – raw materials, labor, and burden. If section 263A applies to the taxpayer, the basic elements

of cost must reflect the current bid price of all direct costs and all indirect costs properly allocable to goods on hand at the inventory date.

Inventory may be valued below cost when the merchandise is unsalable at normal prices or unusable in the normal way because the goods are subnormal due to damage, imperfections, shopwear, etc., within the meaning of Regulations section 1.471-2(c). The goods may be valued at a bona fide selling price minus direct cost of disposition (but not less than scrap value). Bona fide selling price means actual offering of goods during a period ending not later than 30 days after the inventory date.

If this is the first year the Last-in, First-out (LIFO) inventory method was either adopted or extended to inventory goods not previously valued under the LIFO method provided in section 472, attach Form 970, Application To Use LIFO Inventory Method, or a statement with the information required by Form 970. Also check the LIFO box on line 9c. On line 9d, enter the amount or the percent of total closing inventories covered under section 472. Estimates are acceptable.

If the corporation changed or extended its inventory method to LIFO and has had to write up its opening inventory to cost in the year of election, report the effect of this write-up as income (line 5, page 1) proportionately over a 3-year period that begins with the tax year of the LIFO election (section 472(d)).

Schedule B. Other Information

Complete all items that apply to the corporation.

Item 2

Enter the business activity and product or service.

Question 4

Answer "Yes" if the corporation filed, or is required to file, Form 8918, Material Advisor Disclosure Statement.

Item 6

Complete item 6 if the corporation: (a) was a C corporation before it elected to be an S corporation or the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation and (b) has net unrealized built-in gain (defined below) in excess of the net recognized built-in gain from prior years.

The corporation is liable for section 1374 tax if (a) and (b) above apply and it has a net recognized built-in gain (section 1374(d)(2)) for its tax year.

The corporation's net unrealized built-in gain is the amount, if any, by which the fair market value of the assets of the corporation at the beginning of its first S corporation year (or as of the date the assets were acquired, for any asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation) exceeds the aggregate adjusted basis of such assets at that time.

Enter the corporation's net unrealized built-in gain reduced by the net recognized built-in gain for prior years. See sections 1374(c)(2) and (d)(1).

Item 7

If the corporation was a C corporation in a prior year, or if it engaged in a tax-free reorganization with a Corporation, enter the amount of any accumulated earnings and profits (AE&P) at the close of its 2010 tax year. For details on figuring AE&P, see section 312. Estimates based on retained earnings at the end of the tax year are acceptable. If the corporation has AE&P, it may be liable for tax imposed on excess net passive income. See the instructions for line 22a, page 1, of Form 1120S for details on this tax.

Question 8

Total receipts is the sum of the following amounts:

- Gross receipts or sales (page 1, line 1a).
- All other income (page 1, lines 4 and 5).
- Income reported on Schedule K, lines 3a, 4, 5a, and 6.
- Income or net gain reported on Schedule K, lines 7, 8a, 9, and 10.
- Income or net gain reported on Form 8825, lines 2, 19, and 20a.

Schedules K and K-1. (General Instructions)

Purpose of Schedules

The corporation is liable for taxes on lines 22a, 22b, and 22c, page 1 of Form 1120S. Shareholders are liable for income tax on their share of the corporation's income (reduced by any taxes paid by the corporation on income). Shareholders must include their share of the income on their tax return whether or not it is distributed to them. Unlike most partnership income, S corporation income is not self-employment income and is not subject to self-employment tax.

Schedule K is a summary schedule of all shareholders' shares of the corporation's income, deductions, credits, etc. All corporations must complete Schedule K.

Schedule K-1 shows each shareholder's individual share. Attach a copy of each shareholder's Schedule K-1 to the Form 1120S filed with the IRS. Keep a copy for the corporation's records and give each shareholder a copy.

Give each shareholder a copy of the Shareholder's Instructions for Schedule K-1 (Form 1120S) or specific instructions for each item reported on the shareholder's Schedule K-1.

Substitute Forms

The corporation does not need IRS approval to use a substitute Schedule K-1 if it is an exact copy of the IRS schedule. The boxes must use the same numbers and titles and must be in the same order and format as on the comparable IRS Schedule K-1. The substitute schedule must include the OMB number. The corporation must provide each

shareholder with the Shareholder's Instructions for Schedule K-1 (Form 1120S) or instructions that apply to the specific items reported on the shareholder's Schedule K-1.

Shareholder's Pro Rata Share Items

General Rule

Items of income, gain, loss, deduction, or credit, etc., are allocated to a shareholder on a daily basis, according to the number of shares of stock held by the shareholder on each day of the corporation's tax year. See the instructions for item F in *Part II. Information About the Shareholder*.

A shareholder who disposes of stock is treated as the shareholder for the day of disposition. A shareholder who dies is treated as the shareholder for the day of their death.

Special Rules

Termination of shareholders interest. If a shareholder terminates his or her interest in a corporation during the tax year, the corporation, with the consent of all affected shareholders (including those whose interest is terminated), may elect to allocate income and expenses, etc., as if the corporation's tax year consisted of 2 separate tax years, the first of which ends on the date of the shareholders termination.

To make the election, the corporation must attach a statement to a timely filed original or amended Form 1120S for the tax year for which the election is made. In the statement the corporation must state that it is electing under section 1377(a)(2) and Regulations section 1.1377-1(b) to treat the tax year as if it consisted of 2 separate tax years. The statement must also explain how the shareholder's entire interest was terminated (e.g., sale or gift), and state that the corporation and each affected shareholder consent to the corporation making the election. A single statement may be filed for all terminating elections made for the tax year. If the election is made, write "Section 1377(a)(2) Election Made" at the top of each affected shareholders Schedule K-1.

Qualifying dispositions. If a qualifying disposition takes place during the tax year, the corporation may make an irrevocable election to allocate income and expenses, etc., as if the corporation's tax year consisted of 2 tax years, the first of which ends on the close of the day the qualifying disposition occurs.

A qualifying disposition is:

1. A disposition by a shareholder of at least 20% of the corporation's outstanding stock in one or more transactions in any 30-day period during the tax year,
2. A redemption treated as an exchange under section 302(a) or 303(a) of at least 20% of the corporation's outstanding stock in one or more transactions in any 30-day period during the tax year, or
3. An issuance of stock that equals at least 25% of the previously outstanding stock to one or more new shareholders in any 30-day period during the tax year.

To make the election the corporation must attach a statement to a timely filed original or amended Form 1120S for the tax year for which the election is made. In the statement the corporation must state that it is electing under Regulations section 1.1368-1(g)(2)(i) to treat the tax year as if it consisted of two separate tax years, give the facts relating to the qualifying disposition (e.g., sale, gift, stock issuance, or redemption), and state that each shareholder who held stock in the corporation during the tax year consents to the election. A single election statement may be filed for all elections made under this special rule for the tax year.

Specific Instructions (Schedule K-1 Only)

How to Complete Schedule K-1

If the return is for a fiscal year or a short tax year, fill in the tax year space at the top of each Schedule K-1. On each Schedule K-1, enter the information about the corporation and the shareholder in Parts I and II of the schedule (items A through F). In Part III, enter the shareholder's pro rata share of each item of income, deduction, and credit and any other information the shareholder needs to prepare his or her tax return.

Codes. In box 10 and boxes 12 through 17, identify each item by entering a code in the column to the left of the dollar amount entry space. These codes are identified in this chapter on the back of Schedule K-1.

Attached statements. Enter an **asterisk (*)** after the code, if any, in the left column for each item for which you have attached a statement providing additional information. For those informational items that cannot be reported as a single dollar amount, enter the code and asterisk in the left column and write "STMT" in the right column to indicate the information is provided on an attached statement. More than one attached statement can be placed on the same sheet of paper and should be identified in alphanumeric order by box number followed by the letter code (if any). For example: "Box 17, Code R – Depletion Information – Oil and Gas" (followed by the information the shareholder needs).

Too few entry spaces on Schedule K-1? If the corporation has more coded items than the number of entry spaces in box 10, or boxes 12 through 17, do not enter a code or dollar amount in the last entry space of the box. In the last entry space, enter an asterisk in the left column and enter "STMT" in the entry space to the right. Report the additional items on an attached statement and provide the box number, the code, description, and dollar amount or information for each additional item. For example: "Box 13, Code J – Work Opportunity Credit – \$1,000."

Special Reporting Requirements for Corporations With Multiple Activities

If items of income, loss, deduction, or credit from more than one activity (determined for purposes of the passive activity loss and credit limitations) are reported on Schedule K-1, the corporation must provide information for each activity to its shareholders.

Special Reporting Requirements for At-Risk Activities

If the corporation is involved in one or more at-risk activities for which a loss is reported on Schedule K-1, the corporation must report information separately for each activity. See section 465(c) for a definition of activities.

The following information must be provided on an attachment to Schedule K-1 for each activity.

1. A statement that the information is a breakdown of at-risk activity loss amounts.
2. The identity of the at-risk activity, the loss amount for the activity, other income and deductions, and any other information that relates to the activity.

PART I. INFORMATION ABOUT THE CORPORATION

On each Schedule K-1, enter the corporation's name, address, and identifying number.

Item C

If the corporation is filing its return electronically, enter "e-file." Otherwise, enter the name of the IRS service center where the corporation will file its return.

PART II. INFORMATION ABOUT THE SHAREHOLDER

On each Schedule K-1, enter the shareholder's name, address, identifying number, and percentage of stock ownership.

Items D and E

For an individual shareholder, enter the shareholder's social security number (SSN) or individual taxpayer identification number (ITIN) in item D. For all other shareholders, enter the shareholder's EIN.

If a single member limited liability company (LLC) owns stock in the corporation, and the LLC is treated as a disregarded entity for federal income tax purposes, enter the owner's identifying number in Item D and the owner's name and address in Item E. The owner must be eligible to be an S corporation shareholder. An LLC that elects to be treated as a corporation for federal income tax purposes is not eligible to be an S corporation shareholder.

Item F

Each shareholder's pro rate share items are figured separately for each period on a daily basis, based on the percentage of stock held by the shareholder on each day.

If there was no change in shareholders or in the relative interest in stock the shareholders owned during the tax year, enter the percentage of total stock owned by each shareholder during the tax year. For example, if shareholders X and Y each owned 50% for the entire tax year, enter 50% in item F for each shareholder. Each shareholder's pro rata share items (boxes 1 through 17 of Schedule K-1) are figured by multiplying the corresponding Schedule K amount by the percentage in item F.

If there was a change in shareholders or in the relative interest in stock the shareholders owned during the tax year, figure the percentage as follows.

- Each shareholder's percentage of ownership is weighted for the number of days in the tax year that stock was owned. For example, A and B each held 50% for half the tax year and A, B, and C held 40%, 40%, and 20%, respectively, for the remaining half of the tax year. The percentage of ownership for the year for A, B, and C is figured as presented in the illustration and is then entered in item F.

	a	b	C (a x b)	
	% of total stock owned	% of tax year held	% of ownership for the year	
a	50	50	25	
	40	50	+20	45
b	50	50	25	
	40	50	+20	45
c	20	50	10	10
Total				100%

- Each shareholder's pro rata share items generally are figured by multiplying the Schedule K amount by the percentage in item F. However, if a shareholder terminated his or her entire interest in the corporation during the year or a qualifying disposition took place, the corporation may elect to allocate income and expenses, etc., as if the tax year consisted of 2 tax years, the first of which ends on the day of the termination or qualifying disposition.

Specific Instructions (Schedules K and K-1, Part III)

Income (Loss)

Reminder: Before entering income items on Schedule K or K-1, reduce each item of passive investment income (within the meaning of section 1362(d)(3)(C)) by its proportionate share of the net passive income tax (Form 1120S, page 1, line 22a).

Line 1. Ordinary Business Income (Loss)

Enter the amount from line 21, page 1. Enter the income or loss without reference to the shareholder's:

- Basis in the stock of the corporation and in any indebtedness of the corporation to the shareholders (section 1366(d)),
- At-risk limitations, and
- Passive activity limitations.

These limitations, if applicable, are determined at the shareholder level.

Line 1 should not include rental activity income (loss) or portfolio income (loss).

Schedule K-1. Enter each shareholder's pro rata share of ordinary business income (loss) in box 1 of Schedule K-1. If the corporation has more than one trade or business activity, identify on an attachment to Schedule K-1 the amount attributable from each separate activity.

Line 2. Net Rental Real Estate Income (Loss)

Enter the net income or loss of the corporation from rental real estate activities from Form 8825. Attach this form to Form 1120S.

Schedule K-1. Enter each shareholder's pro rata share of net rental real estate income (loss) in box 2 of Schedule K-1. If the corporation has more than one rental real estate activity, identify on an attachment to Schedule K-1 the amount from each separate activity.

Line 3. Other Net Rental Income (Loss)

Enter on line 3a the gross income from rental activities other than those reported on Form 8825. Include on line 3a the gain (loss) from line 17 of Form 4797 that is attributable to the sale, exchange, or involuntary conversion of an asset used in a rental activity other than a rental real estate activity.

Enter on line 3b the deductible expenses of the activity. Attach a statement of these expenses to Form 1120S.

Enter on line 3c the net income (loss).

Schedule K-1. Enter in box 3 of Schedule K-1 each shareholder's pro rata share of other net rental income (loss) reported on line 3c of Schedule K. If the corporation has more than one rental activity reported in box 3, identify on an attachment to Schedule K-1 the amount from each activity.

Portfolio Income

See *Portfolio Income* for a comprehensive definition of portfolio income.

Do not reduce portfolio income by deductions allocated to it. Report such deductions (other than interest expense) on line 12d of Schedule K. Report each shareholder's pro rata share in box 12 of Schedule K-1 using codes I, K, and L.

Interest expense allocable to portfolio income is generally investment interest expense. It is reported on line 12b of Schedule K. Report each shareholder's pro rata share of interest expense allocable to portfolio income in box 12 of Schedule K-1 using code H.

Line 4. Interest Income

Enter only taxable portfolio interest on this line. Taxable interest is interest from all sources except interest exempt from tax and interest on tax-free covenant bonds.

Schedule K-1. Enter each shareholder's pro rata share of interest income in box 4 of Schedule K-1.

Line 5a. Ordinary Dividends

Enter only taxable ordinary dividends on line 5a. Include any qualified dividends reported on line 5b.

Schedule K-1. Enter each shareholder's pro rata share of ordinary dividends in box 5a of Schedule K-1.

Line 5b. Qualified Dividends

Enter qualified dividends on line 5b. Except as provided below, qualified dividends are ordinary dividends received from domestic corporations and qualified foreign corporations.

Exceptions. The following dividends are not qualified dividends:

- Dividends the corporation received on any share of stock held for less than 61 days during the 121-day period that began 60 days before the ex-dividend date. When determining the number of days the corporation held the stock, it cannot count certain days during which the corporation's risk of loss was diminished. The ex-dividend date is the first date following the declaration of a dividend on which the purchaser of a stock is not entitled to receive the next dividend payment. When counting the number of days the corporation held the stock, include the day the corporation disposed of the stock but not the day the corporation acquired it.
- Dividends attributable to periods totaling more than 366 days that the corporation received on any share of preferred stock held for less than 91 days during the 181-day period that began 90 days before the ex-dividend date. When determining the number of days the corporation held the stock, do not count certain days during which the corporation's risk of loss was diminished. Preferred dividends attributable to periods totaling less than 367 days are subject to the 61-day holding period rule above.
- Dividends that relate to payments that the corporation is obligated to make with respect to short sales or positions in substantially similar or related property.
- Dividends paid by a regulated investment company that are not treated as qualified dividend income under section 854.
- Dividends paid by a real estate investment trust that are not treated as qualified dividend income under section 857(c).

Qualified foreign corporation. A foreign corporation is a qualified foreign corporation if it is:

1. Incorporated in a possession of the United States or
2. Eligible for benefits of a comprehensive income tax treaty with the United States that the Secretary determines is satisfactory for this purpose and that includes an exchange of information program.

If the foreign corporation does not meet either 1 or 2 above, then it may be treated as a qualified foreign corporation for any dividend paid by the corporation if the stock associated with the dividend paid is readily tradable on an established securities market in the United States.

However, qualified dividends do not include dividends paid by a passive foreign investment company (defined in section 1297) in either the tax year of the distribution or the preceding tax year.

Schedule K-1. Enter each shareholder's pro rata share of qualified dividends in box 5b of Schedule K-1.

Line 6. Royalties

Enter the royalties received by the corporation.

Schedule K-1. Enter each shareholder's pro rata share of royalties in box 6 of Schedule K-1.

Line 7. Net Short-Term Capital Gain (Loss)

Enter the gain (loss) from line 6 of Schedule D (Form 1120S).

Schedule K-1. Enter each shareholder's pro rata share of net short-term capital gain (loss) in box 7 of Schedule K-1.

Line 8a. Net Long-Term Capital Gain (Loss)

Enter the gain or loss that is portfolio income (loss) from Schedule D (Form 1120S), line 13.

Schedule K-1. Enter each shareholder's pro rata share of net long-term capital gain (loss) in box 8a of Schedule K-1.

Caution. *If any gain or loss from lines 6 or 13 of Schedule D is from the disposition of nondepreciable personal property used in a trade or business, it may not be treated as portfolio income. Instead, report it on line 10 of Schedule K and report each shareholder's pro rata share in box 10, code E, of Schedule K-1.*

Line 8b. Collectibles (28%) Gain (Loss)

Figure the amount attributable to collectibles from the amount reported on Schedule D (Form 1120S) line 13. A collectibles gain (loss) is any long-term gain or deductible long-term loss from the sale or exchange of a collectible that is a capital asset.

Collectibles include works of art, rugs, antiques, metal (such as gold, silver, platinum bullion), gems, stamps, coins, alcoholic beverages, and certain other tangible property.

Also, include gain (but not loss) from the sale or exchange of an interest in a partnership or trust held for more than 1 year and attributable to unrealized appreciation of collectibles. For details, see Regulations section 1.1(h)-1. Also attach the statement required under Regulations section 1.1(h)-1(e).

Schedule K-1. Report each shareholder's pro rata share of the collectibles (28%) gain (loss) in box 8b of Schedule K-1.

Line 8c. Unrecaptured Section 1250 Gain

The three types of unrecaptured section 1250 gain must be reported separately on an attached statement to Form 1120S.

- **From the sale or exchange of the corporation's business assets.** Figure this amount for each section 1250 property in Part III of Form 4797 (except property for which gain is reported using the installment method on Form 6252) for which you had an entry in Part I of Form 4797 by subtracting line 26g of Form 4797 from the smaller of line 22 or line 24. Figure the total of these amounts for all section 1250 properties. Generally, the result is the corporation's unrecaptured section 1250 gain. However, if the corporation is reporting gain on the installment method for a section 1250 property held more than 1 year, see the next paragraph.

The total unrecaptured section 1250 gain for an installment sale of section 1250 property held more than 1 year is figured in a manner similar to that used in the preceding paragraph. However, the total unrecaptured section 1250 gain must be allocated to the installment payments received from the sale. To do so, the corporation generally must treat the gain allocable to each installment payment as unrecaptured section 1250 gain until all such gain has been used in full. Figure the unrecaptured section 1250 gain for installment payments received during the tax year as the smaller of (a) the amount from line 26 or line 37 of Form 6252, Installment Sale Income, (whichever applies) or (b) the total unrecaptured section 1250 gain for the sale reduced by all gain reported in prior years (excluding section 1250 ordinary income recapture).

- **From the sale or exchange of an interest in a partnership.** Also report as a separate amount any gain from the sale or exchange of an interest in a partnership attributable to unrecaptured section 1250 gain.
- **From an estate, trust, RIC, or REIT.** If the corporation received a Schedule K-1 or Form 1099-DIV from an estate, a trust, a real estate investment trust (REIT), or a regulated investment company (RIC) reporting "unrecaptured section 1250 gain," do not add it to the corporation's own unrecaptured section 1250 gain. Instead, report it as a separate amount. For example, if the corporation received a Form 1099-DIV from a REIT with unrecaptured section 1250 gain, report it as "Unrecaptured section 1250 gain from a REIT."

Schedule K-1. Report each shareholder's pro rata share of unrecaptured section 1250 gain from the sale or exchange of the corporation's business assets in box 8c of Schedule K-1. If the corporation is reporting unrecaptured section 1250 gain from an estate, trust, REIT, or RIC or from the corporation's sale or exchange of an interest in a partnership (as explained above), enter "STMT" in box 8c and an asterisk (*) in the left column of the box and attach a statement that separately identifies the amount of unrecaptured section 1250 gain from:

- The sale or exchange of the corporations business assets.
- The sale or exchange of an interest in a partnership.
- An estate, trust, REIT, or RIC.

Line 9. Net Section 1231 Gain (Loss)

Enter the net section 1231 gain (loss) from Form 4797, line 7, column (g).

Do not include net gain or loss from involuntary conversions due to casualty or theft. Report net loss from involuntary conversions due to casualty or theft on line 10 of Schedule K (box 10, code B, of Schedule K-1). See the instructions for line 10 on how to report net gain from involuntary conversions.

Schedule K-1. Report each shareholder's pro rata share of net section 1231 gain (loss) in box 9 of Schedule K-1. If the corporation has more than one rental, trade, or business activity, identify on an attachment to Schedule K-1 the amount of section 1231 gain (loss) from each separate activity.

Line 10. Other Income (Loss)

Enter any other item of income or loss not included on lines 1 through 9. On the dotted line to the left of the entry space for line 10, identify the type of income. If there is more than one type of income, attach a statement to Form 1120S that separately identifies each type and amount of income for each of the following five categories. The codes needed for Schedule K-1 reporting are provided for each category.

Other portfolio income (loss) (code A). Portfolio income not reported on lines 4 through 8. Report and identify other portfolio income or loss on an attachment for line 10.

If the corporation holds a residual interest in a REMIC, report on an attachment the shareholder's share of taxable income (net loss) from the REMIC (line 1b of Schedule Q (Form 1066)); excess inclusion (line 2c of Schedule Q (Form 1066)); and section 212 expenses (line 3b of Schedule Q (Form 1066)). Because Schedule Q (Form 1066) is a quarterly statement, the corporation must follow the Schedule Q (Form 1066) instructions to figure the amounts to report to shareholders for the corporation's tax year.

Involuntary conversions (code B). Report net loss from involuntary conversions due to casualty or theft. The amount for this item is shown on Form 4684, Casualties and Thefts, line 41a or 41b.

Each shareholder's pro rata share must be entered on Schedule K-1.

Enter the net gain from involuntary conversions of property used in a trade or business (line 42 of Form 4684) on line 3 of Form 4797.

If there was a gain (loss) from a casualty or theft to property not used in a trade or business or for income-producing purposes, notify the shareholder. The corporation should not complete Form 4684 for this type of casualty or theft. Instead, each shareholder will complete his or her own Form 4684.

1256 contracts and straddles (code C). Report any net gain or loss from section 1256 contracts from Form 6781, Gains and Losses From Section 1256 Contracts and Straddles.

Mining exploration costs recapture (code D). Provide the information shareholders will need to recapture certain mining exploration expenditures. See Regulations section 1.617-3.

Other income (loss) (code E). Include any other type of income, such as:

- Recoveries of tax benefit items (section 111).
- Gambling gains and losses subject to the limitations in section 165(d). Indicate on an attached statement whether or not the corporation is in the trade or business of gambling.
- Disposition of an interest in oil, gas, geothermal, or other mineral properties. Report the following information on an attached statement to Schedule K-1: (a) description of the property, (b) the shareholder's share of the amount realized on the sale, exchange, or involuntary conversion of each property (fair market value of the property for any other disposition, such as a distribution), (c) the shareholder's share of the corporation's adjusted basis in the property (except for oil or gas properties), and (d) total intangible drilling costs, development costs, and mining exploration costs (section 59(e) expenditures) passed through to the shareholder for the property.
- COD income deferred under section 108(i). Report COD income deferred under section 108(i) that must be included in income in the current tax year under section 108(i)(1) or section 108(i)(5)(D)(i) or (ii). For information on events that will cause previously deferred income to be reportable and allocating deferred income to the shareholders, see section 108(i).
- Gain from the sale or exchange of qualified small business (QSB) stock (as defined in the Instructions for Schedule D) that is eligible for the partial section 1202 exclusion. The section 1202 exclusion applies only to small business stock held by the corporation for more than 5 years. Additional limitations apply at the shareholder level. Report each shareholder's share of section 1202 gain on Schedule K-1. Each shareholder will determine if he or she qualifies for the section 1202 exclusion. Report on an attachment to Schedule K-1 for each sale or exchange the name of the qualified small business that issued the stock, the shareholder's share of the corporation's adjusted basis and sales price of the stock, and the dates the stock was bought and sold.
- Gain eligible for section 1045 rollover (replacement stock purchased by the corporation). Include only gain from the sale or exchange of qualified small business stock (as defined in the Instructions for Schedule D) that was deferred by the corporation under section 1045 and reported on Schedule D. See the Instructions for Schedule D for more details. Additional limitations apply at the shareholder level. Report each shareholder's share of the gain eligible for section 1045 rollover on Schedule K-1. Each shareholder will determine if he or she qualifies for the rollover. Report on an attachment to Schedule K-1 for each sale or exchange the name of the qualified small business that issued the stock, the shareholder's share of the corporation's adjusted basis and sales price of the stock, and the dates the stock was bought and sold.
- Gain eligible for section 1045 rollover (replacement stock not purchased by the corporation). Include only gain from the sale or exchange of qualified small business stock (as defined in the Instructions for Schedule D) the corporation held for more than 6 months but that was not deferred by the corporation under section 1045. See the Instructions for Schedule D for more details. A shareholder may be eligible to defer his or her pro rata share of this gain under section 1045 if he or she purchases other qualified small business stock during the 60-day period that began on the date the stock was sold by the corporation. Additional limitations apply at the shareholder level. Report on an attachment to Schedule K-1 for each sale or exchange the name of the qualified small business that

- issued the stock, the shareholder's share of the corporation's adjusted basis and sales price of the stock, and the dates the stock was bought and sold.
- Any gain or loss from lines 5 or 12 of Schedule D that is not portfolio income (for example, gain or loss from the disposition of nondepreciable personal property used in a trade or business).

Schedule K-1. Enter each shareholder's pro rata share of the five other income categories listed above in box 10 of Schedule K-1. Enter the applicable code A, B, C, D, or E (as shown above).

If you are reporting each shareholder's pro rata share of only one type of income under Code E, enter the code with an asterisk (E*) and the dollar amount in the entry space in box 10 and attach a statement that shows the type of income. If you are reporting multiple types of income under code E, enter the code with an asterisk (E*) and enter "STMT" in the entry space in box 10 and attach a statement that shows "Box 10, Code E," and the dollar amount of each type of income.

If the corporation has more than one trade or business or rental activity (for codes B through E), identify on an attachment to Schedule K-1 the amount from each separate activity.

Deductions

Line 11. Section 179 Deduction

A corporation can elect to expense part of the cost of certain property that the corporation purchased and placed in service this year for use in its trade or business or certain rental activities. See the Instructions for Form 4562 for more information.

Complete Part I of Form 4562 to figure the corporation's section 179 deduction. The corporation does not claim the deduction itself, but instead passes it through to the shareholders. Attach Form 4562 to Form 1120S and show the total section 179 deduction on Schedule K, line 11.

Although the corporation cannot take the section 179 deduction, it generally must still reduce the basis of the asset by the amount of the section 179 deduction it elected, regardless of whether any shareholder can use the deduction. However, the corporation does not reduce the basis for any section 179 deduction allocable to a trust or estate because they are not eligible to take the section 179 deduction. See Regulations section 1.179-1(f).

Identify on an attachment to Schedules K and K-1 the cost of any section 179 property placed in service during the year that is qualified enterprise zone, renewal community, qualified section 179 Recovery Assistance, qualified section 179 disaster assistance property, or qualified real property.

See the instructions for line 17d of Schedule K for sales or other dispositions of property for which a section 179 deduction has passed through to shareholders and for the recapture rules if the business use of the property dropped to 50% or less.

Schedule K-1. Report each shareholder's pro rata share of the section 179 expense deduction in box 11 of Schedule K-1. If the corporation has more than one rental, trade, or business activity, identify on an attachment to Schedule K-1 the amount of section 179 deduction from each separate activity.

Do not complete box 11 of Schedule K-1 for any shareholder that is an estate or trust; estates and trusts are not eligible for the section 179 expense deduction.

Line 12a. Contributions

Cash contributions must be supported by a dated bank record or receipt.

Generally, no deduction is allowed for any contribution of \$250 or more unless the corporation obtains a written acknowledgment from the charitable organization that shows the amount of cash contributed, describes any property contributed, and gives an estimate of the value of any goods or services provided in return for the contribution. The acknowledgment must be obtained by the due date (including extensions) of the corporation's return, or if earlier, the date the return is filed. Do not attach the acknowledgment to the tax return, but keep it with the corporation's records. These rules apply in addition to the filing requirements for Form 8283, Noncash Charitable Contributions, described below under *Contributions of property*.

Enter the charitable contributions made during the tax year. Attach a statement to Form 1120S that separately identifies the corporation's contributions for each of the following categories.

The codes needed for Schedule K-1 reporting are provided for each category.

Cash contributions (50%) (code A). Enter the amount of cash contributions subject to the 50% AGI limitation.

Cash contributions (30%) (code B). Enter the amount of cash contributions subject to the 30% AGI limitation.

Noncash contributions (50%) (code C). Enter the amount of noncash contributions subject to the 50% AGI limitation. Do not include the amount of food inventory contributions reported separately on an attached statement. If property other than cash is contributed and the claimed deduction for one item or group of similar items of property exceeds \$5,000, the corporation must give each shareholder a copy of Form 8283, Noncash Charitable Contributions, to attach to the shareholder's return. Attach a statement to Schedule K-1 that shows:

- The shareholder's pro rata share of the amount of the charitable contributions under section 170(e)(3) for qualified food inventory that was donated to charitable organizations for the care of the ill, needy, and infants. The food must meet all the quality and labeling standards imposed by the federal, state, and local laws and regulations. The amount of the charitable contribution for donated food inventory is the **lesser** of **(a)** the basis of the donated food plus one-half of the appreciation (gain if the donated food were sold at fair market value on the date of the gift) or **(b)** twice the amount of the basis of the donated food.

- The shareholder's pro rata share of the net income for the tax year from the corporation's trade or businesses that made the contributions of food inventory.

Qualified conservation contributions. The AGI limit for qualified conservation contributions under section 170(h) is generally 50%. However, if the corporation is a qualified farmer or rancher (farm income is more than 50% of gross income), the AGI limit for qualified conservation contributions of property used in agriculture or livestock production (or available for such production) is 100%. The carryover period is 15 years. Report qualified conservation contributions with a 50% AGI limitation on Schedule K-1 in box 12 using code C. Report qualified conservation contributions with a 100% AGI limitation on Schedule K-1 in box 12 using code G.

Noncash contributions (30%) (code D). Enter noncash contributions subject to the 30% AGI limitation.

Capital gain property to a 50% organization (30%) (code E). Enter the amount of capital gain property contributions subject to the 30% AGI limitation.

Capital gain property (20%) (code F). Enter capital gain property contributions subject to the 20% AGI limitation.

Contributions of property. If the deduction claimed for noncash contributions exceeds \$500, complete Form 8283, Noncash Charitable Contributions, and attach it to Form 1120S.

Shareholders can deduct their pro rata share of the fair market value of property contributions, but will only need to adjust their stock basis by their pro rata share of the property's adjusted basis. Give each shareholder a statement identifying their pro rata share of both the fair market value and adjusted basis of the property.

If the corporation made a qualified conservation contribution under section 170(h), also include the fair market value of the underlying property before and after the donation, as well as the type of legal interest contributed, and describe the conservation purpose furthered by the donation. Give a copy of this information to each shareholder.

If the corporation made a contribution of real property located in a registered historic district, new restrictions apply. Generally, no deductions are allowed for structures or land, (deductions are only allowed for buildings), and the charitable contribution may be reduced if rehabilitation credits were claimed for the building. A \$500 filing fee may apply to certain deductions over \$10,000. See Publication 526 for details.

Nondeductible contributions. Certain contributions made to an organization conducting lobbying activities are not deductible. See section 170(f)(9) for more details.

Caution. An accrual basis S corporation **cannot** elect to treat a contribution as having been paid in the tax year the board of directors authorizes the payment if the contribution is not actually paid until the next tax year.

Contributions (100%) (code G). If the corporation is a qualified farmer or rancher (farm income is more than 50% of gross income), enter qualified conservation contributions of property used in agriculture or livestock production (or available for such production). The contribution must be subject to a restriction that the property remain available for such production. See section 170(b) for details.

Schedule K-1. Report each shareholder's pro rata share of charitable contributions in box 12 of Schedule K-1 using codes A through G for each of the contribution categories shown above. See the above instructions for *Contributions of property* for information on a statement concerning qualified conservation contributions that you may be required to attach to Schedule K-1. The corporation must attach a copy of its Form 8283 to the Schedule K-1 of each shareholder if the deduction for any item or group of similar items of contributed property exceeds \$5,000, even if the amount allocated to any shareholder is \$5,000 or less.

Line 12b. Investment Interest Expense

Include on this line the interest properly allocable to debt on property held for investment purposes. Property held for investment includes property that produces income (unless derived in the ordinary course of a trade or business) from interest, dividends, annuities, or royalties; and gains from the disposition of property that produces those types of income or is held for investment.

Investment interest expense does not include interest expense allocable to a passive activity.

Investment income and investment expenses other than interest are reported on lines 17a and 17b respectively. This information is needed by shareholders to determine the investment interest expense limitation (see Form 4952, Investment Interest Expense Deduction, for details).

Schedule K-1. Report each shareholder's pro rata share of investment interest expense in box 12 of Schedule K-1 using code H.

Lines 12c(1) and 12c(2). Section 59(e)(2) Expenditures

Generally, section 59(e) allows each shareholder to make an election to deduct their pro rata share of the corporation's otherwise deductible qualified expenditures ratably over 10 years (3 years for circulation expenditures), beginning with the tax year in which the expenditures were made (or for intangible drilling and development costs, over the 60-month period beginning with the month in which such costs were paid or incurred).

The term "qualified expenditures" includes only the following types of expenditures paid or incurred during the tax year:

- Circulation expenditures.
- Research and experimental expenditures.
- Intangible drilling and development costs.
- Mining exploration and development costs.

If a shareholder makes the election, the above items are not treated as AMT tax preference items.

Because the shareholders make this election, the corporation cannot deduct these amounts or include them as AMT items on Schedule K-1. Instead, the corporation passes through the information the shareholders need to figure their separate deductions.

On line 12c(1), enter the type of expenditures claimed on line 12c(2). Enter on line 12c(2) the qualified expenditures paid or incurred during the tax year to which an election under section 59(e) may apply. Enter this amount for all shareholders whether or not any shareholder makes an election under section 59(e).

On an attached statement, identify the property for which the expenditures were paid or incurred. If the expenditures were for intangible drilling costs or development costs for oil and gas properties, identify the month(s) in which the expenditures were paid or incurred. If there is more than one type of expenditure or more than one property, provide the amounts (and the months paid or incurred if required) for each type of expenditure separately for each property.

Schedule K-1. Report each shareholder's pro rata share of section 59(e) expenditures in box 12 of Schedule K-1 using code J. On an attached statement, identify (a) the type of expenditure, (b) the property for which the expenditures are paid or incurred, and (c) for oil and gas properties only, the month in which intangible drilling costs and development costs were paid or incurred. If there is more than one type of expenditure or the expenditures are for more than one property, provide each shareholder's pro rata share of the amounts (and the months paid or incurred for oil and gas properties) for each type of expenditure separately for each property.

Line 12d. Other Deductions

Enter deductions not included on lines 11, 12a, 12b, 12c(2), or 14i. On the dotted line to the left of the entry space for line 12d, identify the type of deduction. If there is more than one type of deduction, attach a statement to Form 1120S that separately identifies the type and amount of each deduction for the following ten categories. The codes needed for Schedule K-1 reporting are provided for each category.

Deductions – royalty income (code I). Enter the deductions related to royalty income.

Deductions – portfolio (2% floor) (code K). Enter the deductions related to portfolio income that are subject to the 2% of AGI floor (see the instructions for Schedule A (Form 1040)).

Deductions – portfolio (other) (code L). Enter the amount of any other deductions related to portfolio income.

No deduction is allowed under section 212 for expenses allocable to a convention, seminar, or similar meeting. Because these expenses are not deductible by shareholders, the corporation does not report these expenses on line 12d of Schedule K. The expenses are nondeductible and are reported as such on line 16c of Schedule K and in box 16 of Schedule K-1 using code C.

Preproductive period expenses (code M). If the corporation is required to use an accrual method of accounting under section 448(a)(3), it must capitalize these expenses. If the corporation is permitted to use the cash method, enter the amount of preproductive period expenses that qualify under Regulations section 1.263A-4(d). An election not to capitalize these expenses must be made at the shareholder level. See *Uniform Capitalization Rules* in Pub. 225, Farmer's Tax Guide.

Commercial revitalization deduction from rental real estate activities (code N). Enter the commercial revitalization deduction on line 12d only if it is for a rental real estate activity. If the deduction is for a nonrental building, deduct it on line 19 of Form 1120S.

Reforestation expense deduction (code O). The corporation can elect to deduct a limited amount of its reforestation expenditures paid or incurred during the tax year. The amount the corporation can elect to deduct is limited to \$10,000 for each qualified timber property. See section 194(c) for a definition of reforestation expenditures and qualified timber property. See Notice 2006-47, 2006-20 I.R.B. 892, for details on making the election. The corporation must amortize over 84 months any amount not deducted.

Schedule K-1. Enter the shareholder's pro rata share of allowable reforestation expense in box 12 of Schedule K-1 using code O and attach a statement that provides a description of the qualified timber property. If the corporation is electing to deduct amounts from more than one qualified timber property, provide a description and the amount for each property.

Domestic production activities information (code P). If the corporation is not eligible or chooses not to figure qualified production activities income (QPAI) at the corporate level, attach a statement with the following information to enable each shareholder to figure the domestic production activities deduction.

- Domestic production gross receipts (DPGR).
- Gross receipts from all sources.
- Cost of goods sold allocable to DPGR.
- Cost of goods sold from all sources.
- Total deductions, expenses, and losses directly allocable to DPGR.
- Total deductions, expenses, and losses directly allocable to a non-DPGR class of income.
- Other deductions, expenses, and losses not directly allocable to DPGR or another class of income.
- Form W-2 wages.
- Any other information a shareholder using the section 861 method will need to allocate and apportion cost of goods sold and deductions between domestic production gross receipts and other receipts.

See Form 8903, Domestic Production Activities Deduction, and its instructions for details. If the corporation is eligible and chooses to figure QPAI at the corporate level, see the instructions below.

Qualified production activities income (code Q). If the corporation is eligible and chooses to figure qualified production activities income (QPAI) at the corporate level, use code Q to report the shareholder's pro rata share of the corporation's QPAI. This amount may be less than zero. See the instructions for Form 8903 for details.

Employer's Form W-2 wages (code R). If the corporation is eligible and chooses to report QPAI with code Q, use code R to report the shareholder's pro rata share of employer's Form W-2 wages properly allocable to domestic production gross receipts. See the Instructions for Form 8903 for details.

Other deductions (code S). Include any other deduction, such as:

- Amounts paid by the corporation that would be allowed as itemized deductions on any of the shareholders' income tax returns if they were paid directly by a shareholder for the same purpose. These amounts include, but are not limited to, expenses under section 212 for the production of income other than from the corporation's trade or business. However, do not enter expenses related to portfolio income or investment interest expense reported on line 12b of Schedule K on this line.
- Soil and water conservation expenditures (section 175).
- Endangered species recovery expenditures (section 175).
- Expenditures paid or incurred for the removal of architectural and transportation barriers to the elderly and disabled that the corporation has elected to treat as a current expense. See section 190.
- Interest expense allocated to debt-financed distributions.
- Contributions to a capital construction fund.
- Any penalty on early withdrawal of savings because the corporation withdrew funds from its time savings deposit before its maturity.
- Film and television production expenses. The corporation can elect to deduct certain costs of a qualified film or television production if the aggregate cost of the production does not exceed \$15 million. There is a higher dollar limitation for productions in certain areas. Provide a description of the film or television production on an attached statement. If the corporation makes the election for more than one film or television production, attach a statement to Schedule K-1 that shows each shareholder's pro rata share of the qualified expenditures separately for each production. The deduction is subject to recapture under section 1245 if the election is voluntarily revoked or the production fails to meet the requirements for the deduction.
- Current year section 108(i) OID deduction. In general, if the corporation made a section 108(i) election for income from the cancellation of debt (COD) attributable to the reacquisition of an applicable debt instrument and the corporation issued a debt instrument with original issue discount (OID) that is subject to section 108(i)(2) because of the election, the deduction for all or a portion of the OID that accrues before the first tax year the COD is includible in income is deferred until the COD is includible in income. The aggregate amount of OID that is deferred during this period is generally allowed as a deduction ratably over the 5-year period the COD is includible in income under section 108(i). The amount deferred is limited to the amount of COD subject to the section 108(i) election.

Schedule K-1. Enter each shareholder's pro rata share of the deduction categories listed above in box 12 of Schedule K-1 or provide the required information on an attached statement. Enter the applicable code shown above.

If you are reporting only one type of deduction under Code S, enter code S with an asterisk (S*) and the dollar amount in the entry space in box 12 and attach a statement that shows the box number, code, and type of deduction. If you are reporting multiple types of deductions under code S, enter the code with an asterisk (S*) and enter "STMT" in the dollar amount entry space in box 12 and attach a statement that shows the box number, code, and dollar amount of each type of deduction.

If the corporation has more than one trade or business activity, identify on an attachment to Schedule K-1 the amount for each separate activity.

Credits

Note. Do not attach Form 3800, General Business Credit, to Form 1120S.

Low-Income Housing Credit

Section 42 provides for a credit that may be claimed by owners of low-income residential rental buildings. To qualify for the credit, the corporation must file Form 8609, Low-Income Housing Credit Allocation and Certification, separately with the IRS. Do not attach Form 8609 to Form 1120S. Complete and attach Form 8586, Low-Income Housing Credit, and Form 8609-A, Annual Statement for Low-Income Housing Credit, to Form 1120S.

Line 13a. Low-Income Housing Credit (Section 42(j)(5))

If the corporation invested in a partnership to which the provisions of section 42(j)(5) apply, report on line 13a the credit the partnership reported to the corporation in box 15 of Schedule K-1 (Form 1065) using code A or code C.

Schedule K-1. Report in box 13 of Schedule K-1 each shareholder's pro rata share of the low income housing credit reported on line 13a of Schedule K. Use code A to report the portion of the credit attributable to buildings placed in service before 2008. Use code C to report the portion of the credit attributable to buildings placed in service after 2007. If the corporation has credits from more than one activity, identify on an attachment to Schedule K-1 the amount for each separate activity.

Line 13b. Low-Income Housing Credit (Other)

Report on line 13b any low-income housing credit not reported on line 13a. This includes any credit reported to the corporation in box 15 of Schedule K-1 (Form 1065) using code B or code D.

Schedule K-1. Report in box 13 of Schedule K-1 each shareholder's pro rata share of the low income housing credit reported on line 13b of Schedule K. Use code B to report the portion of the credit attributable to buildings placed in service before 2008. Use code D to report the portion of the credit attributable to buildings placed in service after 2007. If the corporation has credits from more than one rental activity, identify on an attachment to Schedule K-1 the amount for each separate activity.

Line 13c. Qualified Rehabilitation Expenditures (Rental Real Estate)

Enter on line 13c the total qualified rehabilitation expenditures related to rental real estate activities of the corporation. See Form 3468 for details on qualified rehabilitation expenditures.

Caution. *Qualified rehabilitation expenditures for property not related to rental real estate activities must be reported in box 17 using code C.*

Schedule K-1. Report each shareholder's pro rata share of qualified rehabilitation expenditures related to rental real estate activities in box 13 of Schedule K-1 using code E. Attach a statement to Schedule K-1 that provides the information and the shareholder's pro rata share of the amounts for lines 10b through 10j and 10m of Form 3468. See the instructions for Form 3468 for details. If the corporation has credits from more than one rental real estate activity, identify on an attachment to Schedule K-1 the amount for each separate activity.

Line 13d. Other Rental Real Estate Credits

Enter on line 13d any other credit (other than credits reported on lines 13a through 13c) related to rental real estate activities. On the dotted line to the left of the entry space for line 13d, identify the type of credit. If there is more than one type of credit, attach a statement to Form 1120S that identifies the type and amount for each credit. These credits may include any type of credit listed in the instructions for line 13g.

Schedule K-1. Report in box 13 of Schedule K-1 each shareholder's pro rata share of other rental real estate credits using code F. If you are reporting each shareholder's pro rata share of only one type of rental real estate credit under code F, enter the code with an asterisk (F*) and the dollar amount in the entry space in box 13 and attach a statement that shows "Box 13, code F." If you are reporting multiple types of rental real estate credit under code F, enter the code with an asterisk (F*) and enter "STMT" in the entry space in box 13 and attach a statement that shows "Box 13, code F" and the dollar amount of each type of credit. If the corporation has credits from more than one rental real estate activity, identify on the attached statement the amount of each type of credit for each separate activity.

Line 13e. Other Rental Credits

Enter on line 13e any other credit (other than credits reported on lines 13a through 13d) related to rental activities. On the dotted line to the left of the entry space for line 13e, identify the type of credit. If there is more than one type of credit, attach a statement to Form 1120S that identifies the type and amount for each credit. These credits may include any type of credit listed in the instructions for line 13g.

Schedule K-1. Report in box 13 of Schedule K-1 each shareholder's pro rata share of other rental credits using code G. If you are reporting each shareholder's pro rata share of only one type of rental credit under code G, enter the code with an asterisk (G*) and the dollar amount in the entry space in box 13 and attach a statement that shows "Box 13, Code G" and the type of credit. If you are reporting multiple types of rental credit under code G, enter the code with an asterisk (G*) and enter "STMT" in the entry space in box 13 and attach a statement that shows "Box 13, code G" and the dollar amount of

each type of credit. If the corporation has credits from more than one rental activity, identify on the attached statement the amount of each type of credit for each separate activity.

Line 13f. Alcohol and Cellulosic Biofuel Fuels Credit

Enter on line 13f the credit for alcohol used as fuel attributable to trade or business activities. If the credit for alcohol used as fuel is attributable to rental activities, enter the amount on line 13d or 13e.

Figure this credit on Form 6478, Credit for Alcohol Used as Fuel. Attach it to Form 1120S. Include the amount shown on line 7 of Form 6478 in the corporation's income on line 5 of Form 1120S.

See section 40(f) for an election the corporation can make to have the credit not apply.

Schedule K-1. Report in box 13 of Schedule K-1 each shareholder's pro rata share of the credit for alcohol used as a fuel reported on line 13f using code I.

If this credit includes the small ethanol producer credit, identify on a statement attached to each Schedule K-1 (a) the amount of the small producer credit included in the total credit allocated to the shareholder, (b) the number of gallons for which the corporation claimed the small ethanol producer credit, and (c) the corporation's productive capacity for alcohol. If the corporation has credits from more than one activity, identify on an attachment to Schedule K-1 the amount for each separate activity.

Line 13g. Other Credits

Enter on line 13g any other credit, except credits or expenditures shown or listed for lines 13a through 13f or the credit for federal tax paid on fuels (which is reported on line 23c of page 1). On the dotted line to the left of the entry space for line 13g, identify the type of credit. If there is more than one type of credit or if there are any credits subject to recapture, attach a statement to Form 1120S that separately identifies each type and amount of credit and credit recapture information for the following categories. The codes needed for box 13 of Schedule K-1 are provided in the heading for each category.

Undistributed capital gains credit (code H). This credit represents taxes paid on undistributed capital gains by a regulated investment company (RIC) or a real estate investment trust (REIT). As a shareholder of a RIC or REIT, the corporation will receive notice of the amount of tax paid on undistributed capital gains on Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains.

Work opportunity credit (code J). Complete Form 5884 to figure the credit. Attach it to Form 1120S.

Disabled access credit (code K). Complete Form 8826 to figure the credit. Attach it to Form 1120S.

Empowerment zone and renewal community employment credit (code L). Complete Form 8844 to figure the credit. Attach it to Form 1120S.

Credit for increasing research activities (code M). Complete Form 6765 to figure the credit. Attach it to Form 1120S.

Credit for employer social security and Medicare taxes paid on certain employee tips (code N). Complete Form 8846 to figure the credit. Attach it to Form 1120S.

Backup withholding (code O). This credit is for backup withholding on dividends, interest, and other types of income of the corporation.

Other credits (code P). Attach a statement to Form 1120S that identifies the type and amount of any other credits not reported elsewhere. Complete the credit form identified below and attach it to Form 1120S.

- Unused investment credit from the qualifying advanced coal project credit, qualifying gasification project credit, qualifying advanced energy project credit, or qualifying therapeutic discovery project credit allocated from cooperatives.
- Unused investment credit from the rehabilitation credit or energy credit allocated from cooperatives.
- Credits for affected Midwestern disaster area employers (only available from certain fiscal year partnerships, cooperatives, estates, or trusts).
- Orphan drug credit (Form 8820).
- Qualified plug-in electric vehicle credit (Form 8834).
- Renewable electricity, refined coal, and Indian coal production credit (Form 8835). Attach a statement to Form 1120S and Schedule K-1 showing separately the amount of the credit from Part I and from Part II of Form 8835.
- Indian employment credit (Form 8845).
- Biodiesel and renewable diesel fuels credit (Form 8864). Include the amount from line 8 of Form 8864 in the corporation's income on line 5 of Form 1120S. If this credit includes the small agri-biodiesel producer credit, identify on a statement attached to Schedule K-1 (a) the small agri-biodiesel producer credit included in the total credit allocated to the shareholder, (b) the number of gallons for which the corporation claimed the small agri-biodiesel producer credit, and (c) the corporation's productive capacity for agri-biodiesel.
- New markets credit (Form 8874).
- Credit for small employer pension plan startup costs (Form 8881).
- Credit for employer-provided childcare facilities and services (Form 8882).
- Low sulfur diesel fuel production credit (Form 8896).
- Qualified railroad track maintenance credit (Form 8900).
- Distilled spirits credit (Form 8906).
- Nonconventional source fuel credit (Form 8907).
- Energy efficient home credit (Form 8908).
- Energy efficient appliance credit (Form 8909).
- Alternative motor vehicle credit (Form 8910).
- Alternative fuel vehicle refueling property credit (Form 8911).
- Clean renewable energy bond credit (Form 8912). The amount of this credit (excluding any credits from partnerships, estates, and trusts) must also be reported as interest income on line 4 of Schedule K. In addition, the amount of this credit must also be reported on line 17d of Schedule K.

- Midwestern tax credit bond credit (Form 8912). The amount of this credit (excluding any credits from partnerships, estates, and trusts) must also be reported as interest income on line 4 of Schedule K. In addition, the amount of this credit must also be reported on line 17d of Schedule K.
- Qualified zone academy bond credit (for bonds issued before October 4, 2008) (Form 8912). The amount of this credit must also be reported as interest income on line 4 of Schedule K. In addition, the amount of this credit must also be reported on line 17d of Schedule K.
- New clean renewable energy bond credit (Form 8912). The amount of this credit (excluding any credits from partnerships, estates, and trusts) must also be reported as interest income on line 4 of Schedule K. In addition, the amount of this credit must also be reported as a property distribution on line 16d of Schedule K.
- Qualified energy conservation bond credit (Form 8912). The amount of this credit (excluding any credits from partnerships, estates, and trusts) must also be reported as interest income on line 4 of Schedule K. In addition, the amount of this credit must also be reported as a property distribution on line 16d of Schedule K.
- Qualified forestry conservation bond credit (Form 8912). The amount of this credit (excluding any credits from partnerships, estates, and trusts) must also be reported as interest income on line 4 of Schedule K. In addition, the amount of this credit must also be reported as a property distribution on line 16d of Schedule K.
- Qualified zone academy bond credit (for bonds issued after October 3, 2008) (Form 8912). The amount of this credit (excluding any credits from partnerships, estates, and trusts) must also be reported as interest income on line 4 of Schedule K. In addition, the amount of this credit must also be reported as a property distribution on line 16d of Schedule K.
- Qualified school construction bond credit (Form 8912). The amount of this credit (excluding any credits from partnerships, estates, and trusts) must also be reported as interest income on line 4 of Schedule K. In addition, the amount of this credit must also be reported as a property distribution on line 16d of Schedule K.
- Build America bond credit (Form 8912). The amount of this credit (excluding any credits from partnerships, estates, and trusts) must also be reported as interest income on line 4 of Schedule K. In addition, the amount of this credit must also be reported as a property distribution on line 16d of Schedule K.
- Mine rescue team training credit (Form 8923).
- Agricultural chemicals security credit (Form 8931).
- Credit for employer differential wage payments (Form 8932).
- Carbon dioxide sequestration credit (Form 8933).
- Qualified plug-in electric drive motor vehicle credit (Form 8936).
- Credit for small employer health insurance premiums (Form 8941).
- General credits from an electing large partnership.

Schedule K-1. Enter in box 13 of Schedule K-1 each shareholder's pro rata share of the credit and credit recapture categories listed above. See additional Schedule K-1 reporting information provided in the instructions above. Enter the applicable code, H through P, in the column to the left of the dollar amount entry space.

If you are reporting each shareholder's pro rata share of only one type of credit under code P, enter the code with an asterisk (P*) and the dollar amount in the entry space in box 13 and attach a statement that shows "Box 13, code P" and the type of credit. If you are reporting multiple types of credit under code P, enter the code with an asterisk (P*) and enter "STMT" in the entry space in box 13 and attach a statement that shows "Box 13, code P" and the dollar amount of each type of credit. If the corporation has credits from more than one activity, identify on an attachment to Schedule K-1 the amount of each type of credit for each separate activity. See *Passive Activity Reporting Requirements*.

Foreign Transactions

Line 14b must be completed if a shareholder may need this information to figure a foreign tax credit. Lines 14a and 14c through 14n must be completed if the corporation has foreign income, deductions, or losses, or has paid or accrued foreign taxes.

On Schedule K-1, for items that require an attached statement, enter the code followed by an asterisk and the shareholder's pro rata share of the dollar amount. Attach a statement to Schedule K-1 for these coded items providing the information described below. If the corporation had income from, or paid or accrued taxes to, more than one country or U.S. possession, see the requirement for an attached statement in the instruction for line 14a below. See Pub. 514, Foreign Tax Credit for Individuals, and the Instructions for Form 1116, for more information.

Line 14a. Name of Country or U.S. Possession (Code A)

Enter the name of the foreign country or U.S. possession from which the corporation had income or to which the corporation paid or accrued taxes. If the corporation had income from, or paid or accrued taxes to, more than one foreign country or U.S. possession, enter "See attached" and attach a statement for each country for lines 14a through 14n (codes A through N and code Q of Schedule K-1). On Schedule K-1, if there is more than one country enter code A followed by an asterisk (A*), enter "STMT," and attach a statement to Schedule K-1 for each country for the information and amounts coded A through N and code Q.

Line 14b. Gross Income From all Sources (Code B)

Enter the corporation's gross income from all sources (both U.S. and foreign).

Line 14c. Gross Income Sourced at Shareholder Level (Code C)

Enter the total gross income of the corporation that is required to be sourced at the shareholder level. This includes income from the sale of most personal property, other than inventory, depreciable property, and certain intangible property. See Pub. 514 and section 865 for details. Attach a statement to Form 1120S showing the following information:

- The amount of this gross income (without regard to its source) in each category identified in the instructions for lines 14d, 14e, and 14f.

- Specifically identify gains on the sale of personal property other than inventory, depreciable property, and certain intangible property on which a foreign tax of 10% or more was paid or accrued. Also list losses on the sale of such property if the foreign country would have imposed a 10% or higher tax had the sale resulted in a gain. See *Sales or Exchanges of Certain Personal Property* in Pub. 514 and section 865.
- Specify foreign source capital gains or losses within each separate limitation category. Also separately identify foreign source gains or losses within each separate limitation category that are collectibles (28%) gains and losses or unrecaptured section 1250 gains.

Lines 14d-14f. Foreign Gross Income Sourced at Corporate Level

Separately report gross income from sources outside the United States by category of income as follows. See Pub. 514 for more information on the categories of income.

Line 14d. Passive category (code D). Passive category foreign source income.

Line 14e. General category (code E). General category foreign source income. Include all foreign income sourced at the corporate level that is not reported on lines 14d and 14f.

Line 14f. Other (code F). Attach a statement showing the amount of foreign source income included in each of the following categories.

- Section 901(j) income.
- Income re-sourced by treaty.

Lines 14g-14h. Deductions Allocated and Apportioned at Shareholder Level

Line 14g. Interest expense (code G). Enter the corporation's total interest expense (including interest equivalents under Temporary Regulations section 1.861-9T(b)). Do not include interest directly allocable under Temporary Regulations section 1.861-10T to income from a specific property. This type of interest is allocated and apportioned at the corporate level and is included on lines 14i through 14k.

Line 14h. Other (code H). Enter the total of all other deductions or losses that are required to be allocated at the shareholder level. For example, include on line 14h research and experimental expenditures.

Lines 14i-14k. Deductions Allocated and Apportioned at Corporate Level to Foreign Source Income

Separately report corporate deductions that are apportioned at the corporate level to (a) passive foreign source income, (b) each of the listed foreign categories of income (14e), and (c) general limitation foreign source income (see the instructions for lines 14d-14f). Attach a statement showing the amount of deductions allocated and apportioned at the corporate level to each of the listed categories from line 14f.

Lines 14l. Total Foreign Taxes Paid or Accrued

Enter in U.S. dollars the total foreign taxes (described in section 901 or section 903) that were paid or accrued according to the corporation's method of accounting for such taxes. Translate these amounts into U.S. dollars by using the applicable exchange rate.

Foreign taxes paid (code L). If the corporation used the cash method of accounting, check the "Paid" box and enter foreign taxes paid during the tax year. Report each shareholder's pro rata share in box 14 of Schedule K-1 using code L.

Foreign taxes accrued (code M). If the corporation uses the accrual method of accounting, check the "Accrued" box and enter foreign taxes accrued. Report each shareholder's pro rata share in box 14 of Schedule K-1 using code M.

A corporation reporting foreign taxes using the cash method can make an irrevocable election to report the taxes using the accrual method for the year of the election and all future years. Make this election by reporting all foreign taxes using the accrual method on line 14l and checking the "Accrued" box.

Attach a statement reporting the following information:

1. The total amount of foreign taxes (including foreign taxes on income sourced at the shareholder level) relating to each category of income (see instructions for lines 14d-14f).
2. The dates on which the taxes were paid or accrued, the exchange rates used, and the amounts in both foreign currency and U.S. dollars, for the following:
 - Taxes withheld at source on interest.
 - Taxes withheld at source on dividends.
 - Taxes withheld at source on rents and royalties.
 - Other foreign taxes paid or accrued.

Line 14m. Reduction in Taxes Available for Credit (Code N)

Enter the total reductions in taxes available for credit. Attach a schedule showing the reductions for:

- Taxes on foreign mineral income (section 901(e)).
- Taxes on foreign oil and gas extraction income (section 907(a)).
- Taxes attributable to boycott operations (section 908).
- Failure to timely file (or furnish all of the information required on) Forms 5471 and 8865.
- Any other items (specify).

Line 14n. Other Foreign Tax Information

- **Foreign trading gross receipts (code O).** Report each shareholder's pro rata share of foreign trading gross receipts from line 15 of Form 8873 in box 14 using code O. See *Extraterritorial Income Exclusion*.

- **Extraterritorial income exclusion (code P).** If the corporation is not permitted to deduct the extraterritorial income exclusion as a nonseparately stated item, attach a statement to Schedule K-1 showing the shareholder's pro rata share of the extraterritorial income exclusion reported on line 52 of Form 8873. Also identify the activity to which the exclusion is related.
- **Other foreign transactions (code Q).** Report any other foreign transaction information the shareholders need to prepare their tax returns.

ALTERNATIVE MINIMUM TAX (AMT) ITEMS

Lines 15a through 15f must be completed for all shareholders.

Enter items of income and deductions that are adjustments or tax preference items for the alternative minimum tax (AMT). See Form 6251, Alternative Minimum Tax—Individuals, or Schedule I of Form 1041, U.S. Income Tax Return for Estates and Trusts, for more information.

Do not include as a tax preference item any qualified expenditures to which an election under section 59(e) may apply. Instead, report these expenditures on line 12(c)(2). Because these expenditures are subject to an election by each shareholder, the corporation cannot figure the amount of any tax preference related to them. Instead, the corporation must pass through to each shareholder in box 12, code J, of Schedule K-1 the information needed to figure the deduction.

Schedule K-1. Report each shareholder's pro rata share of amounts reported on lines 15a through 15f in box 15 of Schedule K-1 using codes A through F respectively.

If the corporation is reporting items of income or deduction for oil, gas, and geothermal properties, you may be required to identify these items on a statement attached to Schedule K-1 (see the instructions for lines 15d and 15e below for details). Also see the requirement for an attached statement in the instructions for line 15f.

Line 15a. Post-1986 Depreciation Adjustment

Figure the adjustment for line 15a based only on tangible property placed in service after 1986 (and tangible property placed in service after July 31, 1986, and before 1987 for which the corporation elected to use the general depreciation system). Do not make an adjustment for motion picture films, videotapes, sound recordings, certain public utility property (as defined in section 168(f)(2)), property depreciated under the unit-of-production method (or any other method not expressed in a term of years), qualified Indian reservation property, property eligible for a special depreciation allowance, qualified revitalization expenditures, or the section 179 expense deduction.

For property placed in service before 1999, refigure depreciation for the AMT as follows (using the same convention used for the regular tax):

- For section 1250 property (generally, residential rental and nonresidential real property), use the straight line method over 40 years.
- For tangible property (other than section 1250 property) depreciated using the straight line method for the regular tax, use the straight line method over the property's class life. Use 12 years if the property has no class life.

- For any other tangible property, use the 150% declining balance method, switching to the straight line method the first tax year it gives a larger deduction, over the property's AMT class life. Use 12 years if the property has no class life.

For property placed in service after 1998, refigure depreciation for the AMT only for property depreciated for the regular tax using the 200% declining balance method. For the AMT, use the 150% declining balance method, switching to the straight line method the first tax year it gives a larger deduction, and the same convention and recovery period used for the regular tax.

Figure the adjustment by subtracting the AMT deduction for depreciation from the regular tax deduction and enter the result on line 15a. If the AMT deduction is more than the regular tax deduction, enter the difference as a negative amount. Depreciation capitalized to inventory must also be refigured using the AMT rules. Include on this line the current year adjustment to income, if any, resulting from the difference.

Line 15b. Adjusted Gain or Loss

If the corporation disposed of any tangible property placed in service after 1986 (or after July 31, 1986, if an election was made to use the General Depreciation System), or if it disposed of a certified pollution control facility placed in service after 1986, refigure the gain or loss from the disposition using the adjusted basis for the AMT. The property's adjusted basis for the AMT is its cost or other basis minus all depreciation or amortization deductions allowed or allowable for the AMT during the current tax year and previous tax years. Enter on this line the difference between the regular tax gain (loss) and the AMT gain (loss). If the AMT gain is less than the regular tax gain, or the AMT loss is more than the regular tax loss, or there is an AMT loss and a regular tax gain, enter the difference as a negative amount.

If any part of the adjustment is allocable to net short-term capital gain (loss), net long-term capital gain (loss), or net section 1231 gain (loss), attach a statement that identifies the amount of the adjustment allocable to each type of gain or loss.

For a net long-term capital gain (loss), also identify the amount of the adjustment that is collectibles (28%) gain (loss).

For a net section 1231 gain (loss), also identify the amount of adjustment that is unrecaptured section 1250 gain.

Line 15c. Depletion (Other Than Oil and Gas)

Do not include any depletion on oil and gas wells. The shareholders must figure their oil and gas depletion deductions and preference items separately under section 613A.

Refigure the depletion deduction under section 611 for mines, wells (other than oil and gas wells), and other natural deposits for the AMT. Percentage depletion is limited to 50% of the taxable income from the property as figured under section 613(a), using only income and deductions for the AMT. Also, the deduction is limited to the property's adjusted basis at the end of the year as figured for the AMT. Figure this limit separately for each property. When refiguring the property's adjusted basis, take into account any AMT adjustments made this year or in previous years that affect basis (other than the current year's depletion).

Enter the difference between the regular tax and AMT deduction. If the AMT deduction is greater, enter the difference as a negative amount.

Oil, Gas, and Geothermal Properties – Gross Income and Deductions

Generally, the amounts to be entered on lines 15d and 15e are only the income and deductions for oil, gas, and geothermal properties that are used to figure the corporation's ordinary business income (loss) on line 21, page 1, Form 1120S.

If there are any items of income or deductions for oil, gas, and geothermal properties included in the amounts that are required to be passed through separately to the shareholders on Schedule K-1, give each shareholder a schedule that shows, for the box in which the income or deduction is included, the amount of income or deductions included in the total amount for that box. Do not include any of these direct pass-through amounts on line 15d or 15e. The shareholder is told in the Shareholder's Instructions for Schedule K-1 (Form 1120S) to adjust the amounts in box 15, code D or E, for any other income or deductions from oil, gas, or geothermal properties included in boxes 2 through 12, 16 or 17 of Schedule K-1 in order to determine the total income and deductions from oil, gas, and geothermal properties for the corporation.

Figure the amounts for lines 15d and 15e separately for oil and gas properties that are not geothermal deposits and for all properties that are geothermal deposits.

Give each shareholder a schedule that shows the separate amounts included in the computation of the amounts on lines 15d and 15e of Schedule K.

Line 15d. Oil, Gas, and Geothermal Properties – Gross Income

Enter the total amount of gross income (within the meaning of section 613(a)) from all oil, gas, and geothermal properties received or accrued during the tax year and included on page 1, Form 1120S.

Line 15e. Oil, Gas, and Geothermal Properties – Deductions

Enter the amount of any deductions allowed for the AMT that are allocable to oil, gas, and geothermal properties.

Line 15f. Other AMT Items

Attach a schedule to Form 1120S and Schedule K-1 that shows other items not shown on lines 15a through 15e that are adjustments or tax preference items or that the shareholder needs to complete Form 6251 or Schedule I of Form 1041. See these forms and their instructions to determine the amount to enter.

Other AMT items include the following:

- Accelerated depreciation of real property under pre-1987 rules.
- Accelerated depreciation of leased personal property under pre-1987 rules.
- Long-term contracts entered into after February 28, 1986. Except for certain home construction contracts, the taxable income from these contracts must be figured using the percentage of completion method of accounting for the AMT.

- Losses from tax shelter farm activities. No loss from any tax shelter farm activity is allowed for the AMT.

Schedule K-1. If you are reporting each shareholder's pro rata share of only one type of AMT item under code F, enter the code with an asterisk (F*) and the dollar amount in the entry space in box 15 and attach a statement that shows the type of AMT item. If you are reporting multiple types of AMT items under code F, enter the code with an asterisk (F*) and enter "STMT" in the entry space in box 15 and attach a statement that shows the dollar amount of each type of AMT item.

Items Affecting Shareholder Basis

Line 16a. Tax-Exempt Interest Income

Enter on line 16a tax-exempt interest income, including any exempt-interest dividends received from a mutual fund or other regulated investment company. This information must be reported by individuals on line 8b of Form 1040. Generally, under section 1367(a)(1)(A), the basis of the shareholder's stock is increased by the amount shown on this line.

Line 16b. Other Tax-Exempt Income

Enter on line 16b all income of the corporation exempt from tax other than tax-exempt interest (e.g., life insurance proceeds, but see section 101(j) for new limits and reporting requirements). Generally, under section 1367(a)(1)(A), the basis of the shareholder's stock is increased by the amount shown on this line.

Line 16c. Nondeductible Expenses

Enter on line 16c nondeductible expenses paid or incurred by the corporation.

Do not include separately stated deductions shown elsewhere on Schedules K and K-1, capital expenditures, or items for which the deduction is deferred to a later tax year.

Generally, under section 1367(a)(2)(D), the basis of the shareholder's stock is decreased by the amount shown on this line.

Line 16d. Distributions

Enter the total distributions (including cash) made to each shareholder other than dividends reported on line 17c of Schedule K. Include the shareholder's pro rata share of any amounts included in interest income with respect to new clean renewable energy, qualified energy conservation, qualified forestry conservation, qualified zone academy bonds (for bonds issued after October 3, 2008), qualified school construction, or build America bonds. Distributions of appreciated property are valued at fair market value. If property other than cash was distributed, attach a statement to provide the following information: (1) the date the property was acquired, (2) the date the property was distributed, (3) the property's FMV on the date of distribution, and (4) the corporation's basis in the property.

Line 16e. Repayment of Loans From Shareholders

Enter any repayments made to shareholders during the current tax year.

Schedule K-1. Report each shareholder's pro rata share of amounts reported on lines 16a, 16b, and 16c (concerning items affecting shareholder basis) in box 16 of Schedule K-1 using codes A through C respectively. Report property distributions (line 16d) and repayment of loans from shareholders (line 16e) on the Schedule K-1 of the shareholder(s) that received the distributions or repayments (using codes D and E).

Other Information

Lines 17a and 17b. Investment Income and Expenses

Enter on line 17a the investment income included on lines 4, 5a, 6 and 10, of Schedule K. Do not include other portfolio gains or losses on this line.

Enter on line 17b the investment expense included on line 12d of Schedule K.

Investment income includes gross income from property held for investment, the excess of net gain attributable to the disposition of property held for investment over net capital gain from the disposition of property held for investment, any net capital gain from the disposition of property held for investment that each shareholder elects to include in investment income under section 163(d)(4)(B)(iii), and any qualified dividend income that the shareholder elects to include in investment income. Generally, investment income and investment expenses do not include any income or expenses from a passive activity. See Regulations section 1.469-2(f)(10) for exceptions.

Property subject to a net lease is not treated as investment property because it is subject to the passive loss rules. Do not reduce investment income by losses from passive activities.

Investment expenses are deductible expenses (other than interest) directly connected with the production of investment income. See the Instructions for Form 4952 for more information.

Schedule K-1. Report each shareholder's pro rata share of amounts reported on lines 17a and 17b (investment income and expenses) in box 17 of Schedule K-1 using codes A and B respectively.

If there are other items of investment income or expense included in the amounts that are required to be passed through separately to the shareholders on Schedule K-1, such as net short-term capital gain or loss, net long-term capital gain or loss, and other portfolio gains or losses, give each shareholder a statement identifying these amounts.

Line 17c. Dividend Distributions Paid From Accumulated Earnings and Profits (Schedule K Only)

Enter total dividends paid to shareholders from accumulated earnings and profits. Report these dividends to shareholders on Form 1099-DIV. Do not report them on Schedule K-1.

Line 17d. Other Items and Amounts

Report the following information on a statement attached to Form 1120S. In box 17 of Schedule K-1 enter the appropriate code for each information item followed by an asterisk in the left-hand column of the entry space (e.g., C*). In the right-hand column, enter "STMT". The codes are provided for each information category.

Qualified rehabilitation expenditures (other than rental real estate) (code C). Enter total qualified rehabilitation expenditures from activities other than rental real estate activities. See Form 3468 for details on qualified rehabilitation expenditures.

Note. Report qualified rehabilitation expenditures related to rental real estate activities on line 13c.

Schedule K-1. Report each shareholder's pro rata share of qualified rehabilitation expenditures related to other than rental real estate activities in box 17 of Schedule K-1 using code C. Attach a statement to Schedule K-1 that provides the information and the shareholder's pro rata share of the amounts for lines 11b through 11j and 11m of Form 3468. See the instructions for Form 3468 for details. If the corporation has expenditures from more than one activity, identify on a statement attached to Schedule K-1 the information and amounts for each separate activity. See *Passive Activity Reporting Requirements*.

Basis of energy property (code D). In box 17 of Schedule K-1, enter code D followed by an asterisk and enter "STMT" in the entry space for the dollar amount. Attach a statement to Schedule K-1 that provides the shareholder's pro rata share of the basis and capacity amounts the shareholder will need to figure the amounts to report on lines 12a-d, 12f, 12g, 12i, 12j, 12l, 12m, 12o, and 12q-12s of Form 3468. See the instructions for Form 3468 for details.

Recapture of low-income housing credit (codes E and F). If recapture of part or all of the low-income housing credit is required because (a) the prior year qualified basis of a building decreased or (b) the corporation disposed of a building or part of its interest in a building, see Form 8611, Recapture of Low-Income Housing Credit. Complete lines 1 through 7 of Form 8611 to figure the amount of the credit to recapture.

Use code E on Schedule K-1 to report recapture of the low-income housing credit from a section 42(j)(5) partnership. Use code F to report recapture of any other low-income housing credit. See the instructions for lines 13a and 13b for more information.

Note. If a shareholder's ownership interest in a building decreased because of a transaction at the shareholder level, the corporation must provide the necessary information to the shareholder to enable the shareholder to figure the recapture.

Caution. *The disposal of a building or an interest therein will generate a credit recapture unless it is reasonably expected that the building will continue to be operated as a qualified low-income building for the remainder of the building's compliance period.*

See Form 8586, Form 8611, and section 42 for more information.

Recapture of investment credit (code G). Complete and attach Form 4255 when investment credit property is disposed of, or it no longer qualifies for the credit, before the end of the recapture period or the useful life applicable to the property. State the type of property at the top of Form 4255, and complete lines 2, 4, and 5, whether or not any shareholder is subject to recapture of the credit.

Attach to each Schedule K-1 a separate statement providing the information the corporation is required to show on Form 4255, but list only the shareholder's pro rata share of the cost of the property subject to recapture. Also indicate the lines of Form 4255 on which the shareholder's should report these amounts.

The corporation itself is liable for investment credit recapture in certain cases. See Investment credit recapture tax, earlier, for details.

Recapture of other credits (code H). On an attached statement to Schedule K-1, provide any information shareholders will need to report recapture of credits (other than recapture of low-income housing credit and investment credit reported on Schedule K-1 using codes E, F, and G). Examples of credits subject to recapture and reported using code H include:

- The qualified plug-in electric vehicle credit. See section 30(e)(5) for details.
- The qualified plug-in electric drive motor vehicle credit. See section 30D(e)(8) for details.
- The new markets credit. See Form 8874 for details.
- The Indian employment credit. See section 45A(d) for details.
- The credit for employer-provided childcare facilities and services. See section 45F(d) for details.
- The alternative motor vehicle credit. See section 30B(h)(8) for details.
- The alternative fuel vehicle refueling property credit. See section 30C(e)(5) for details.

Lookback interest – completed long-term contracts (code I). If the corporation is closely held (defined in section 460(b)(4)(C)(iii)) and it entered into any long-term contracts after February 28, 1986, that are accounted for under either the percentage of completion-capitalized cost method or the percentage of completion method, it must attach a schedule to Form 1120S showing the information required in items (a) and (b) of the instructions for lines 1 and 3 of Part II of Form 8697. It must also report the amounts for Part II, lines 1 and 3, to its shareholders.

Lookback interest – income forecast method (code J). If the corporation is closely held (defined in section 460(b)(4)(C)(iii)) and it depreciated certain property placed in service after September 13, 1995, under the income forecast method, it must attach to Form 1120S the information specified in the instructions for Form 8866, line 2, for the 3rd and 10th tax years beginning after the tax year the property was placed in service. It must also report the line 2 amounts to its shareholders. See the Instructions for Form 8866 for more details.

Dispositions of property with section 179 deductions (code K). This represents gain or loss on the sale, exchange, or other disposition of property for which a section 179 deduction has been passed through to shareholders. The corporation must provide all the following information with respect to such dispositions (see the instructions for line 4).

- Description of the property.
- Date the property was acquired and placed in service.
- Date of the sale or other disposition of the property.
- The shareholder's pro rata share of the gross sales price or amount realized.
- The shareholder's pro rata share of the cost or other basis plus expense of sale (reduced as explained in the instructions for Form 4797, line 21).
- The shareholder's pro rata share of the depreciation allowed or allowable, determined as described in the instructions for Form 4797, line 22, but excluding the section 179 deduction.
- The shareholder's pro rata share of the section 179 deduction (if any) passed through for the property and the corporation's tax year(s) in which the amount was passed through.
- If the disposition is due to a casualty or theft, a statement indicating so, and any additional information needed by the shareholder.
- For an installment sale made during the corporation's tax year, any information needed to complete Form 6252. The corporation also must separately report the shareholder's pro rata share of all payments received for the property in future tax years. (Installment payments received for installment sales made in prior tax years should be reported in the same manner used in prior tax years.)

Recapture of section 179 deduction (code L). This amount represents recapture of section 179 deduction if business use of the property dropped to 50% or less. If the business use of any property (placed in service after 1986) for which a section 179 deduction was passed through to shareholders dropped to 50% or less (for a reason other than disposition), the corporation must provide all the following information.

- The shareholder's pro rata share of the original basis and depreciation allowed or allowable (not including the section 179 deduction).
- The shareholder's pro rata share of the section 179 deduction (if any) passed through for the property and the corporation's tax year(s) in which the amount was passed through.

Section 453(l)(3) information (code M). Supply any information needed by a shareholder to compute the interest due under section 453(l)(3). If the corporation elected to report the dispositions of certain timeshares and residential lots on the installment method, each shareholder's tax liability must be increased by the shareholder's pro rata share of the interest on tax attributable to the installment payments received during the tax year.

Section 453A(c) information (code N). Supply any information needed by a shareholder to compute the interest due under section 453A(c). If an obligation arising from the disposition of property to which section 453A applies is outstanding at the close of the year, each shareholder's tax liability must be increased by the tax due under section 453A(c) on the shareholder's pro rata share of the tax deferred under the installment method.

Section 1260(b) information (code O). Supply any information needed by a shareholder to figure the interest due under section 1260(b). If the corporation had gain from certain constructive ownership transactions, each shareholder's tax liability must be increased by the shareholder's pro rata share of interest due on any deferral of gain recognition. See section 1260(b) for details, including how to figure the interest.

Interest allocable to production expenditures (code P). Supply any information needed by a shareholder to properly capitalize interest as required by section 263A(f).

CCF nonqualified withdrawal (code Q). Report nonqualified withdrawals by the corporation from a capital construction fund. Attach a statement to the shareholder's Schedule K-1 providing details of the withdrawal.

Depletion information—oil and gas (code R). Report gross income and other information relating to oil and gas well properties to shareholders to allow them to figure the depletion deduction for oil and gas well properties. Allocate to each shareholder a proportionate share of the adjusted basis of each corporate oil or gas property. See section 613A(c)(11) for details.

The corporation cannot deduct depletion on oil and gas wells. Each shareholder must determine the allowable amount to report on his or her return.

Amortization of reforestation costs (code S). Report the amortizable basis of reforestation expenditures paid or incurred before October 23, 2004, for which the corporation elected amortization, and the tax year the amortization began for the current tax year and the 7 preceding tax years. The amortizable basis cannot exceed \$10,000 for each of those tax years.

Section 108(i) information (code T). Report the shareholder's pro rata share of the following.

- Any COD income deferred under section 108(i) that has not been included in income in the current or prior tax years.
- Any OID deduction deferred under section 108(i)(2)(A)(i) that has not been deducted in the current or prior tax years.

Other information (code U). Report to each shareholder:

1. If the corporation participates in a transaction that must be disclosed on Form 8886, both the corporation and its shareholders may be required to file Form 8886. The corporation must determine if any of its shareholders are required to disclose the transaction and provide those shareholders with information they will need to file Form 8886. This determination is based on the category(s) under which a transaction qualified for disclosures. See the instructions for Form 8886 for details.
2. If the corporation is involved in farming or fishing activities, report the gross income from these activities.
3. If the corporation has deductions attributable to a farming business and receives and applicable subsidy, report the aggregate gross income or gain and the aggregate deductions from the farming business. See section 461(j) for details.
4. The shareholder's pro rata share of any amount included in interest income on line 4 with respect to clean renewable energy, Midwestern tax credit, or (for bonds issued before October 4, 2008) qualified zone academy bonds. Shareholders need this information to properly adjust their stock basis. See Form 8912.

5. Any income or gain reported on lines 1 through 10 of Schedule K that qualifies as inversion gain, if the corporation is an expatriated entity or is a partner in an expatriated entity. For details, see section 7874. Attach a statement to Form 1120S that shows the amount of each type of income or gain included in the inversion gain. The corporation must report each shareholder's pro rata share of the inversion gain in box 17 of Schedule K-1 using code U. Attach a statement to Schedule K-1 that shows the shareholder's pro rata share of the amount of each type of income or gain included in the inversion gain.
6. Basis in qualifying advanced coal project property. Attach a statement to Schedule K-1 that provides the shareholder's pro rata share of the basis amounts the shareholder will need to figure the amounts to report on lines 5a, 5b, and 5c of Form 3468. See the instructions for Form 3468 for details.
7. Basis in qualifying gasification project property. See Form 3468 for details on basis in qualifying gasification project property. Attach a statement to Schedule K-1 that provides the shareholder's pro rata share of the basis amounts the shareholder will need to figure the amounts to report on lines 6a and 6b of Form 3468. See the instructions for Form 3468 for details.
8. Basis in qualifying advanced energy project property. Attach a statement to Schedule K-1 that provides the shareholder's pro rata share of the basis amounts the shareholder will need to figure the amounts to report on line 7 of Form 3468. See the Instructions for Form 3468 for details.
9. Qualifying therapeutic discovery project credit. Attach a statement to Schedule K-1 that provides the shareholder's pro rata share of the basis amounts the shareholder will need to figure the amount to report on line 8 of Form 3468. See the Instructions for Form 3468 for details.
10. Eligible small business. An S corporation is an eligible small business if its average annual gross receipts for the three preceding tax years were \$50 million or less (see section 38(c)(5)(C) for details). The corporation must tell shareholders whether the corporation qualifies as an eligible small business if it reports any general business credits on Schedule K-1. General business credits are reported using one or more of the following boxes on Schedule K-1.
 - Box 13.
 - Box 17 using code C or D.
 - Box 17 using Code U for items (6) through (9) above.
 - Any other information the shareholders need to prepare their tax returns.

Reconciliation

Line 18. Income/Loss Reconciliation (Schedule K only)

To the extent the corporation has an amount on line 12d for code O (Domestic production activities information), P (Qualified production activities income), or Q (Employer's Form W-2 wages), exclude the amount(s) from line 18. If the corporation has an amount on line 14l of Schedule K (foreign taxes paid and accrued), add that amount for purposes of computing the corporation's net income (loss). The amount reported on line 18 must be the same as the amount reported on line 8 of Schedule M-1, or line 26, column d, in Part II of Schedule M-3 (Form 1120S).

Schedule L. Balance Sheets Per Books

The balance sheet should agree with the corporation's books and records. Schedule L is not required to be completed if the corporation answered "Yes" to question 8 on Schedule B. If the corporation is required to complete Schedule L, include total assets reported on Schedule L, line 15, column (d), on page 1, item F.

Corporations with total assets of \$10 million or more on the last day of the tax year must complete Schedule M-3 (Form 1120S) instead of Schedule M-1. See the separate instructions for Schedule M-3 (Form 1120S) for provisions also affecting Schedule L.

If the S election terminated during the tax year and the corporation reverted to a C corporation, the year-end balance sheet generally should agree with the books and records at the end of the C short year. However, if the corporation elected under section 1362(e)(3) to have items assigned to each short year under normal tax accounting rules, the year-end balance sheet should agree with the books and records at the end of the S short year.

Line 5. Tax-Exempt Securities

Include on this line:

- State and local government obligations, the interest on which is excludible from gross income under section 103(a), and
- Stock in a mutual fund or other regulated investment company that distributed exempt-interest dividends during the tax year of the corporation.

Line 24. Retained Earnings

If the corporation maintains separate accounts for appropriated and unappropriated retained earnings, it may want to continue such accounting for purposes of preparing its financial balance sheet. Also, if the corporation converts to C corporation status in a subsequent year, it will be required to report its appropriated and unappropriated retained earnings on separate lines of Schedule L of Form 1120.

Line 25. Adjustments to Shareholders' Equity

Some examples of adjustments to report on this line include:

- Unrealized gains and losses on securities held "available for sale."
- Foreign currency translation adjustments.
- The excess of additional pension liability over unrecognized prior service cost.
- Guarantees of employee stock (ESOP) debt.
- Compensation related to employee stock award plans.

If the total adjustment to be entered is a negative amount, enter the amount in parentheses.

Schedule M-1. Reconciliation of Income (Loss) Per Books with Income (Loss) Per Return

Schedule M-1 is not required to be completed if the corporation answered “Yes” to question 8 on Schedule B.

Corporations with total assets of \$10 million or more on the last day of the tax year must complete Schedule M-3 instead of Schedule M-1. See *Item C, Schedule M-3 Information*, earlier. A corporation filing Form 1120S that is not required to file Schedule M-3 may voluntarily file Schedule M-3. See the Instructions for Schedule M-3 (Form 1120S) for more information.

Line 2

Report on this line income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10 not recorded on the books this year. Describe each such item of income. Attach a statement if necessary.

Line 3b. Travel and Entertainment

Include any of the following:

- Meals and entertainment not allowed under section 274(n).
- Expenses for the use of an entertainment facility.
- The part of business gifts over \$25.
- Expenses of an individual over \$2,000, which are allocable to conventions on cruise ships.
- Employee achievement awards over \$400.
- The cost of entertainment tickets over face value (also subject to 50% limit).
- The cost of skyboxes over the face value of nonluxury box seat tickets.
- The part of luxury water travel not deductible under section 274(m).
- Expenses for travel as a form of education.
- Other nondeductible travel and entertainment expenses.

Note. If the corporation has an amount on line 14l of Schedule K (foreign taxes paid and accrued), take that amount into account for purposes of determining the amount of expenses and deductions to enter on lines 3 and 6.

Schedule M-2. Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders’ Undistributed Taxable Income Previously Taxed

Column (A). Accumulated Adjustments Account

The accumulated adjustments account (AAA) is an account of the S corporation that generally reflects the accumulated undistributed net income of the corporation for the corporation’s post-1982 years. S corporations with accumulated E&P must maintain the AAA to determine the tax effect of distributions during S years and the post-termination

transition period. An S corporation without accumulated E&P does not need to maintain the AAA in order to determine the tax effect of distributions. Nevertheless, if an S corporation without accumulated E&P engages in certain transactions to which section 381(a) applies, such as a merger into an S corporation with accumulated E&P, the S corporation must be able to calculate its AAA at the time of the merger for purposes of determining the tax effect of post-merger distributions. Therefore, it is recommended that the AAA be maintained by all S corporations.

On the first day of the corporation's first tax year as an S corporation, the balance of the AAA is zero. At the end of the tax year, adjust the AAA for the items as explained below and in the order listed.

1. Increase the AAA by income (other than tax-exempt income) and the excess of the deduction for depletion over the basis of the property subject to depletion (unless the property is an oil and gas property the basis of which has been allocated to shareholders).
2. Generally, decrease the AAA by deductible losses and expenses, nondeductible expenses (other than expenses related to tax-exempt income and federal taxes attributable to a C corporation tax year), and the sum of the shareholders' deductions for depletion for any oil or gas property held by the corporation as described in section 1367(a)(2)(E). If deductible losses and expenses include the fair market value of contributed property, further adjust AAA by adding back the fair market value of the contributed property and subtracting instead the property's adjusted basis. If the total decreases under 2 exceed the total increases under 1 above, the excess is a "net negative adjustment." If the corporation has a net negative adjustment, do not take it into account under 2. Instead, take it into account only under 4 below.
3. Decrease AAA (but not below zero) by property distributions (other than dividend distributions from accumulated E&P), unless the corporation elects to reduce accumulated E&P first. See *Distributions* below for definitions and other details.
4. Decrease AAA by any net negative adjustment. For adjustments to the AAA for redemptions, reorganizations, and corporate separations, see Regulations section 1.1368-2(d).

Note. The AAA may have a negative balance at year end.

Column (b). Other Adjustments Account

The other adjustments account is adjusted for tax-exempt income (and related expenses) and federal taxes attributable to a C corporation tax year. After these adjustments are made, the account is reduced for any distributions made during the year. See *Distributions* below.

Column (c). Shareholders' Undistributed Taxable Income Previously Taxed

The shareholders' undistributed taxable income previously taxed account, also called previously taxed income (PTI), is maintained only if the corporation had a balance in this account at the start of its 2010 tax year. If there is a beginning balance for the 2010 tax year, no adjustments are made to the account except to reduce the account for distributions made under section 1375(d) (as in effect before the enactment of the Subchapter S Revision Act of 1982).

Each shareholder's right to nontaxable distributions from PTI is personal and cannot be transferred to another person. The corporation is required to keep records of each shareholder's net share of PTI.

Distributions

General rule. Unless the corporation makes one of the elections described below, property distributions (including cash) are applied in the following order (to reduce accounts of the S corporation that are used to figure the tax effect of distributions made by the corporation to its shareholders):

1. Reduce the AAA determined without regard to any net negative adjustment for the tax year (but not below zero). If distributions during the tax year exceed the AAA at the close of the tax year determined without regard to any net negative adjustment for the tax year, the AAA is allocated pro rata to each distribution made during the tax year. See section 1368.
2. Reduce shareholders' PTI account for any section 1375(d) (as in effect before 1983) distributions. A distribution from the PTI account is tax free to the extent of a shareholder's basis in his or her stock in the corporation.
3. Reduce accumulated E&P. Generally, the S corporation has accumulated E&P only if it has not distributed E&P accumulated in prior years when the S corporation was a C corporation (section 1361(a)(2)). See section 312 for information on E&P. The only adjustments that can be made to the accumulated E&P of an S corporation are (a) reductions for dividend distributions; (b) adjustments for redemptions, liquidations, reorganizations, etc.; and (c) reductions for investment credit recapture tax for which the corporation is liable. See sections 1371(c) and (d)(3).
4. Reduce the other adjustments account (OAA).
5. Reduce any remaining shareholders' equity accounts.

Elections relating to source of distributions. The corporation may modify the above ordering rules by making one or more of the following elections.

Election to distribute accumulated E&P first. If the corporation has accumulated E&P and wants to distribute from this account before making distributions from the AAA, it may elect to do so with the consent of all its affected shareholders (section 1368(e)(3)(B)). This election is irrevocable and applies only for the tax year for which it is made.

Election to make a deemed dividend. If the corporation wants to distribute all or part of its accumulated E&P through a deemed dividend, it may elect to do so with the consent of all its affected shareholders (section 1368(e)(3)(B)). Under this election, the corporation will be treated as also having made the election to distribute accumulated E&P first. The amount of the deemed dividend cannot exceed the accumulated E&P at the end of the tax year. The E&P at year end is first reduced by any actual distributions of accumulated E&P made during the tax year. A deemed dividend is treated as if it were a pro rata distribution of money to the shareholders, received by the shareholders, and immediately contributed back to the corporation, all on the last day of the tax year. This election is irrevocable and applies only for the tax year for which it is made.

Election to forego PTI. If the corporation wants to forego distributions of PTI, it may elect to do so with the consent of all its affected shareholders (section 1368(e)(3)(B)). Under this election, paragraph 2 under the *General rule* above does not apply to any distribution made during the tax year. This election is irrevocable and applies only for the tax year for which it is made.

Statement regarding elections. To make any of the above elections, the corporation must attach a statement to a timely filed original or amended Form 1120S for the tax year for which the election is made. In the statement, the corporation must identify the election it is making and must state that each shareholder consents to the election. The statement of election to make a deemed dividend must include the amount of the deemed dividend distributed to each shareholder.

Example.

The following example shows how the Schedule M-2 accounts are adjusted for items of income (loss), deductions, and distributions reported on Form 1120S. In this example, the corporation has no PTI or accumulated E&P.

Items per return are:

1. Page 1, line 21 income—\$10,000
2. Schedule K, line 2 loss—(\$3,000)
3. Schedule K, line 4 income—\$4,000
4. Schedule K, line 5a income— \$16,000
5. Schedule K, line 12a deduction— \$24,000
6. Schedule K, line 12d deduction— \$3,000
7. Schedule K, line 13g work opportunity credit—\$6,000
8. Schedule K, line 16a tax-exempt interest—\$5,000
9. Schedule K, line 16c nondeductible expenses—\$6,000 (reduction in salaries and wages for work opportunity credit), and
10. Schedule K, line 16d distributions—\$65,000.

Based on items 1 through 10 above and starting balances of zero, the columns for the AAA and the other adjustments account are completed as shown in the Schedule M-2 Worksheet.

For the AAA, the worksheet line 3 – \$20,000 amount is the total of the Schedule K, lines 4 and 5a income of \$4,000 and \$16,000. The worksheet line 5 – \$36,000 amount is the total of the Schedule K, line 2 loss of (\$3,000), line 12a (code A) deduction of \$24,000, line 12d (code S) deduction of \$3,000, and the line 16c nondeductible expenses of \$6,000. The worksheet line 7 is zero. The AAA at the end of the tax year (figured without regard to distributions and the net negative adjustment of \$6,000) is zero, and distributions cannot reduce the AAA below zero.

For the other adjustments account, the worksheet line 3 amount is the Schedule K, line 16a, tax-exempt interest income of \$5,000. The worksheet line 7 amount is \$5,000, reducing the other adjustments account to zero. The remaining \$60,000 of distributions are not entered on Schedule M-2.

Schedule M-2 Worksheet			
	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1. Balance at beginning of tax year	-0-	-0-	
2. Ordinary income from page 1, line 21	10,000		
3. Other additions	20,000	5,000	
4. Loss from page 1, line 21	()		
5. Other reductions	(36,000)	()	
6. Combine line 1 through 5	(6,000)	5,000	
7. Distributions other than dividend distributions	-0-	5,000	
8. Balance at end of year. Subtract line 7 from line 6	(6,000)	-0-	

U.S. Income Tax Return for an S Corporation

2010

▶ Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.
▶ See separate instructions.

For calendar year 2010 or tax year beginning _____, 2010, ending _____, 20

A S election effective date	TYPE OR PRINT	Name	D Employer identification number
B Business activity code number (see instructions)		Number, street, and room or suite no. If a P.O. box, see instructions.	E Date incorporated
C Check if Sch. M-3 attached <input type="checkbox"/>		City or town, state, and ZIP code	F Total assets (see instructions)
		\$	

G Is the corporation electing to be an S corporation beginning with this tax year? Yes No If "Yes," attach Form 2553 if not already filed

H Check if: (1) Final return (2) Name change (3) Address change
(4) Amended return (5) S election termination or revocation

I Enter the number of shareholders who were shareholders during any part of the tax year _____ ▶

Caution. Include only trade or business income and expenses on lines 1a through 21. See the instructions for more information.

Income	1 a Gross receipts or sales	b Less returns and allowances	c Bal ▶	1c		
	2 Cost of goods sold (Schedule A, line 8)			2		
	3 Gross profit. Subtract line 2 from line 1c			3		
	4 Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)			4		
	5 Other income (loss) (see instructions—attach statement)			5		
	6 Total income (loss). Add lines 3 through 5			▶	6	
Deductions (see instructions for limitations)	7 Compensation of officers			7		
	8 Salaries and wages (less employment credits)			8		
	9 Repairs and maintenance			9		
	10 Bad debts			10		
	11 Rents			11		
	12 Taxes and licenses			12		
	13 Interest			13		
	14 Depreciation not claimed on Schedule A or elsewhere on return (attach Form 4562)			14		
	15 Depletion (Do not deduct oil and gas depletion.)			15		
	16 Advertising			16		
	17 Pension, profit-sharing, etc., plans			17		
	18 Employee benefit programs			18		
	19 Other deductions (attach statement)			19		
	20 Total deductions. Add lines 7 through 19			▶	20	
	21 Ordinary business income (loss). Subtract line 20 from line 6				21	
Tax and Payments	22 a Excess net passive income or LIFO recapture tax (see instructions)	22a				
	b Tax from Schedule D (Form 1120S)	22b				
	c Add lines 22a and 22b (see instructions for additional taxes)			22c		
	23 a 2010 estimated tax payments and 2009 overpayment credited to 2010	23a				
	b Tax deposited with Form 7004	23b				
	c Credit for federal tax paid on fuels (attach Form 4136)	23c				
	d Add lines 23a through 23c			23d		
	24 Estimated tax penalty (see instructions). Check if Form 2220 is attached <input type="checkbox"/>			24		
	25 Amount owed. If line 23d is smaller than the total of lines 22c and 24, enter amount owed			25		
	26 Overpayment. If line 23d is larger than the total of lines 22c and 24, enter amount overpaid			26		
27 Enter amount from line 26 Credited to 2011 estimated tax ▶			Refunded ▶	27		

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Sign Here	Signature of officer _____ Date _____ Title _____		May the IRS discuss this return with the preparer shown below (see instructions)? <input type="checkbox"/> Yes <input type="checkbox"/> No
	Print/Type preparer's name _____ Preparer's signature _____ Date _____		
Paid Preparer Use Only	Firm's name ▶ _____		Check <input type="checkbox"/> if self-employed
	Firm's address ▶ _____		Firm's EIN ▶ _____
			Phone no. _____

Schedule A Cost of Goods Sold (see instructions)

1	Inventory at beginning of year	1		
2	Purchases	2		
3	Cost of labor	3		
4	Additional section 263A costs (attach statement)	4		
5	Other costs (attach statement)	5		
6	Total. Add lines 1 through 5	6		
7	Inventory at end of year	7		
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on page 1, line 2	8		

9a Check all methods used for valuing closing inventory: *fj* Cost as described in Regulations section 1.471-3
ij Lower of cost or market as described in Regulations section 1.471-4
ijj Other (Specify method used and attach explanation.) ▶

b Check if there was a writedown of subnormal goods as described in Regulations section 1.471-2(c) ▶

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO **9d** _____

e If property is produced or acquired for resale, do the rules of section 263A apply to the corporation? Yes No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? . . . Yes No
 If "Yes," attach explanation.

Schedule B Other Information (see instructions)

	Yes	No
1 Check accounting method: a <input type="checkbox"/> Cash b <input type="checkbox"/> Accrual c <input type="checkbox"/> Other (specify) ▶ _____		
2 See the instructions and enter the: a Business activity ▶ _____ b Product or service ▶ _____		
3 At the end of the tax year, did the corporation own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a statement showing: (a) name and employer identification number (EIN), (b) percentage owned, and (c) if 100% owned, was a qualified subchapter S subsidiary election made?		
4 Has this corporation filed, or is it required to file, Form 8918 , Material Advisor Disclosure Statement, to provide information on any reportable transaction?		
5 Check this box if the corporation issued publicly offered debt instruments with original issue discount ▶ <input type="checkbox"/> If checked, the corporation may have to file Form 8281 , Information Return for Publicly Offered Original Issue Discount Instruments.		
6 If the corporation: (a) was a C corporation before it elected to be an S corporation or the corporation acquired an asset with a basis determined by reference to the basis of the asset (or the basis of any other property) in the hands of a C corporation and (b) has net unrealized built-in gain in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years (see instructions) ▶ \$ _____		
7 Enter the accumulated earnings and profits of the corporation at the end of the tax year. \$ _____		
8 Are the corporation's total receipts (see instructions) for the tax year and its total assets at the end of the tax year less than \$250,000? If "Yes," the corporation is not required to complete Schedules L and M-1		
9 During the tax year, was a qualified subchapter S subsidiary election terminated or revoked? If "Yes," see instructions		

Schedule K Shareholders' Pro Rata Share Items

	Total amount
1 Ordinary business income (loss) (page 1, line 21)	1
2 Net rental real estate income (loss) (attach Form 8825)	2
3a Other gross rental income (loss) 3a _____	
b Expenses from other rental activities (attach statement) 3b _____	
c Other net rental income (loss). Subtract line 3b from line 3a 3c _____	
4 Interest income	4
5 Dividends: a Ordinary dividends 5a _____	
b Qualified dividends 5b _____	
6 Royalties	6
7 Net short-term capital gain (loss) (attach Schedule D (Form 1120S))	7
8a Net long-term capital gain (loss) (attach Schedule D (Form 1120S))	8a
b Collectibles (28%) gain (loss) 8b _____	
c Unrecaptured section 1250 gain (attach statement) 8c _____	
9 Net section 1231 gain (loss) (attach Form 4797)	9
10 Other income (loss) (see instructions) . . . Type ▶ _____	10

		Shareholders' Pro Rata Share Items (continued)	Total amount	
Deductions	11	Section 179 deduction (attach Form 4562)	11	
	12a	Contributions	12a	
	b	Investment interest expense	12b	
	c	Section 59(e)(2) expenditures (1) Type ▶ (2) Amount ▶	12c(2)	
	d	Other deductions (see instructions) Type ▶	12d	
Credits	13a	Low-income housing credit (section 42(j)(5))	13a	
	b	Low-income housing credit (other)	13b	
	c	Qualified rehabilitation expenditures (rental real estate) (attach Form 3468)	13c	
	d	Other rental real estate credits (see instructions) Type ▶	13d	
	e	Other rental credits (see instructions) Type ▶	13e	
	f	Alcohol and cellulosic biofuel fuels credit (attach Form 6478)	13f	
	g	Other credits (see instructions) Type ▶	13g	
Foreign Transactions	14a	Name of country or U.S. possession ▶		
	b	Gross income from all sources	14b	
	c	Gross income sourced at shareholder level <i>Foreign gross income sourced at corporate level</i>	14c	
	d	Passive category	14d	
	e	General category	14e	
	f	Other (attach statement) <i>Deductions allocated and apportioned at shareholder level</i>	14f	
	g	Interest expense	14g	
	h	Other <i>Deductions allocated and apportioned at corporate level to foreign source income</i>	14h	
	i	Passive category	14i	
	j	General category	14j	
	k	Other (attach statement) <i>Other information</i>	14k	
	l	Total foreign taxes (check one): ▶ <input type="checkbox"/> Paid <input type="checkbox"/> Accrued	14l	
	m	Reduction in taxes available for credit (attach statement)	14m	
n	Other foreign tax information (attach statement)			
Alternative Minimum Tax (AMT) Items	15a	Post-1986 depreciation adjustment	15a	
	b	Adjusted gain or loss	15b	
	c	Depletion (other than oil and gas)	15c	
	d	Oil, gas, and geothermal properties—gross income	15d	
	e	Oil, gas, and geothermal properties—deductions	15e	
	f	Other AMT items (attach statement)	15f	
Items Affecting Shareholder Basis	16a	Tax-exempt interest income	16a	
	b	Other tax-exempt income	16b	
	c	Nondeductible expenses	16c	
	d	Distributions (attach statement if required) (see instructions)	16d	
	e	Repayment of loans from shareholders	16e	
Other Information	17a	Investment income	17a	
	b	Investment expenses	17b	
	c	Dividend distributions paid from accumulated earnings and profits	17c	
	d	Other items and amounts (attach statement)		
Reconciliation	18	Income/loss reconciliation. Combine the amounts on lines 1 through 10 in the far right column. From the result, subtract the sum of the amounts on lines 11 through 12d and 14l	18	

Schedule L Balance Sheets per Books		Beginning of tax year		End of tax year	
		(a)	(b)	(c)	(d)
Assets					
1	Cash				
2a	Trade notes and accounts receivable				
b	Less allowance for bad debts	()		()	
3	Inventories				
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)				
6	Other current assets (attach statement)				
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach statement)				
10a	Buildings and other depreciable assets				
b	Less accumulated depreciation	()		()	
11a	Depletable assets				
b	Less accumulated depletion	()		()	
12	Land (net of any amortization)				
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	()		()	
14	Other assets (attach statement)				
15	Total assets				
Liabilities and Shareholders' Equity					
16	Accounts payable				
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (attach statement)				
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more				
21	Other liabilities (attach statement)				
22	Capital stock				
23	Additional paid-in capital				
24	Retained earnings				
25	Adjustments to shareholders' equity (attach statement)				
26	Less cost of treasury stock	()		()	
27	Total liabilities and shareholders' equity				

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return			
Note: Schedule M-3 required instead of Schedule M-1 if total assets are \$10 million or more—see instructions			
1	Net income (loss) per books	5	Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize):
2	Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize):	a	Tax-exempt interest \$
3	Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 14l (itemize):	6	Deductions included on Schedule K, lines 1 through 12 and 14l, not charged against book income this year (itemize):
a	Depreciation \$	a	Depreciation \$
b	Travel and entertainment \$	7	Add lines 5 and 6
4	Add lines 1 through 3	8	Income (loss) (Schedule K, line 18), Line 4 less line 7

Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (see instructions)			
	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1	Balance at beginning of tax year		
2	Ordinary income from page 1, line 21		
3	Other additions		
4	Loss from page 1, line 21	()	
5	Other reductions	()	
6	Combine lines 1 through 5		
7	Distributions other than dividend distributions		
8	Balance at end of tax year. Subtract line 7 from line 6		

Schedule K-1 (Form 1120S)
Shareholder's Share of Income, Deductions, Credits, etc.
(For Shareholder's Use Only)

I. General Instructions

PURPOSE OF SCHEDULE K-1

The corporation uses Schedule K-1 (Form 1120S) to report your pro rata share of the corporation's income (reduced by any tax the corporation paid on the income), deductions, credits, etc. Keep it for your records. Do not file it with your tax return. The corporation has filed a copy with the IRS.

You are liable for income tax on your share of the corporation's income, whether or not distributed. Include your share on your tax return if a return is required.

Your share of S corporation income is not self-employment income and it is not subject to self-employment tax.

The amount of loss and deduction that you may claim on your tax return may be less than the amount reported on Schedule K-1. It is the shareholder's responsibility to consider and apply any applicable limitations. See *Limitations on Losses, Deductions, and Credits* for more information.

Schedule K-1 does not show the amount of actual dividend distributions the corporation made to you. The corporation must report such amounts totaling \$10 or more for the calendar year on Form 1099-DIV, Dividends and Distributions.

ELECTIONS

Generally, the corporation decides how to figure taxable income from its operations. However, certain elections are made by you separately on your income tax return and not by the corporation. These elections are made under the following code sections:

- Section 59(e) (deduction of certain qualified expenditures ratably over the period of time specified in that section). For details, see the instructions for code J in box 12.
- Section 263A(d) (preproductive expenses). See the instructions for code M in box 12.
- Section 617 (deduction and recapture of certain mining exploration expenditures).
- Section 901 (foreign tax credit).

Limitations on Losses, Deductions, and Credits

There are three separate potential limitations on the amount of losses passed to the shareholder that you may deduct on your return. These limitations and the order in which you must apply them are as follows: the basis rules, the at-risk limitations, and the passive activity limitations. Each of these limitations is discussed separately below.

Other limitations may apply to specific deductions (for example, the section 179 expense deduction). Generally, specific limitations apply before the basis, at-risk, and passive loss limitations.

Basis Rules

Generally, the deduction for your share of aggregate losses and deductions reported on Schedule K-1 is limited to the basis of your stock (determined with regard to distributions received during the tax year) and loans from you to the corporation. The basis of your stock is figured at year-end. Any losses and deductions not allowed this year because of the basis limit can be carried forward indefinitely and deducted in a later year subject to the basis limit for that year.

You are responsible for maintaining records to show the computation of the basis of your stock in the corporation. Schedule K-1 provides information to help you make the computation at the end of each corporate tax year. The basis of your stock (generally, its cost) is adjusted as follows and, except as noted, in the order listed. In addition, basis may be adjusted under other provisions of the Internal Revenue Code. You can generally use the worksheet, later, to figure your aggregate stock basis.

1. Basis is increased by (a) all income (including tax-exempt income) reported on Schedule K-1 and (b) the excess of the deduction for depletion (other than oil and gas depletion) over the basis of the property subject to depletion.

Caution. You must report the taxable income on your return (if you are required to file one) for it to increase your basis.

Caution. Basis is not increased by income from discharge of your indebtedness in the S corporation (nor by any amount included in income with respect to clean renewable energy, Gulf tax credit, Midwestern tax credit, or (for bonds issued before October 4, 2008) qualified zone academy bonds).

2. Basis is decreased by: (a) property distributions (including cash) made by the corporation reported on Schedule K-1, box 16, code D, minus (b) the amount of such distributions in excess of the basis in your stock.
3. Basis is decreased by: (a) nondeductible expenses, and (b) the depletion deduction for any oil and gas property held by the corporation, but only to the extent your pro rata share of the property's adjusted basis exceeds that deduction.
4. Basis is decreased by all deductible losses and deductions reported on Schedule K-1 adjusted, if the corporation made a charitable contribution of property, by subtracting the property's fair market value and adding the property's adjusted basis.

You may elect to decrease your basis under (4) above prior to decreasing your basis under (3) above. If you make this election, any amount described under (3) that exceeds the basis of your stock and debt owed to you by the corporation is treated as an amount described under 3 for the following tax year.

To make the election, attach a statement to your timely filed original or amended return that states you agree to the carryover rule of Regulations section 1.1367-1(g) and the name of the S corporation to which the rule applies. Once made, the election applies to the year for which it is made and all future tax years for that S corporation, unless the IRS agrees to revoke your election.

The basis of each share of stock is increased or decreased (but not below zero) based on its pro rata share of the above adjustments. If the total decreases in basis attributable to a share exceed that share's basis, the excess reduces (but not below zero) the remaining bases of all other shares of stock in proportion to the remaining basis of each of those shares.

Worksheet for Figuring a Shareholder's Stock Basis <i>Keep for your records</i>	
1. Your stock basis at the beginning of the year	1. _____
Increases:	
2. Money and your adjusted basis in property contributed to the corporation	2. _____
3. Your share of the corporation's income (including tax-exempt income) reduced by any amount included in income with respect to clean renewable energy, Gulf tax credit, Midwestern tax credit, or (for bonds issued before October 4, 2008) qualified zone academy bonds	3. _____
4. Other increases to basis, including your share of the excess of the deductions for depletion (other than oil and gas depletion) over the basis of the property subject to depletion	4. _____
Decreases:	
5. Distributions of money and the fair market value of property (excluding dividend distributions reportable on Form 1099-DIV and distributions in excess of basis (the sum of lines 1 through 4))	5. (_____)
6. Enter: (a) your share of the corporation's nondeductible expenses and the depletion deduction for any oil and gas property held by the corporation (but only to the extent your pro rata share of the property's adjusted basis exceeds the depletion deduction), or (b) if the election under Regulations section 1.1367-1(g) applies, your share of the corporation's deductions and losses (include your entire share of the section 179 expense deduction even if your allowable section 179 expense deduction is smaller) adjusted, if the corporation made a charitable contribution of property, by subtracting your share of the fair market value of the contributed property and adding your share of the property's adjusted basis	6. (_____)
7. If the election under Regulations section 1.1367-1(g) applies, enter the amount from 6(a) above. Otherwise, enter the amount from 6(b)	7. (_____)
8. Enter the smaller of: (a) the excess, as of the beginning of the tax year, of the amount you are owed for loans you made to the corporation over your basis in those loans, or (b) the sum of lines 1 through 7. This amount increases your loan basis	8. (_____)
9. Your stock basis in the corporation at end of year. Combine lines 1 through 8	9. _____

Basis of loans. The basis of your loans to the corporation is generally the balance the corporation owes you, adjusted for any reductions and restorations of loan basis (see the instructions for box 16, code E). Any amounts described in 3 and 4 above not used to offset amounts in 1 above, or reduce your stock basis, are used to reduce your loan basis (to the extent of such basis prior to such reduction).

Caution. *When determining your basis in loans to the corporation, remember that:*

- *Distributions do not reduce loan basis, and*
- *Loans that a shareholder guarantees or co-signs are not part of a shareholder's loan basis.*

Worksheet instructions. For lines 6 and 7, do not enter more than the aggregate sum of the preceding lines. Any excess of the amounts that would otherwise be entered on lines 6 and 7 without regard to this limit over the amounts actually entered on those lines is a reduction to your basis, if any, in loans you made to the corporation (to the extent of such basis). Any portion of the excess not used to reduce your basis in stock and loans is not deductible in the current year and is carried over to next year and subject to that year's basis limit. See the preceding instructions for more details.

At-Risk Limitations

Generally, you will have to complete Form 6198, At-Risk Limitations, to figure your allowable loss, if you have:

1. A loss or other deduction from any activity carried on by the corporation as a trade or business or for the production of income, and
2. Amounts in the activity for which you are not at risk.

The at-risk rules generally limit the amount of loss and other deductions that you can claim to the amount you could actually lose in the activity. These losses and deductions include a loss on the disposition of assets and the section 179 expense deduction. However, if you acquired your stock before 1987, the at-risk rules do not apply to losses from an activity of holding real property placed in service before 1987 by the corporation. The activity of holding mineral property does not qualify for this exception. The corporation should identify on an attachment to Schedule K-1 the amount of any losses that are not subject to the at-risk limitations.

Generally, you are not at risk for amounts such as the following:

- The basis of your stock in the corporation or basis of your loans to the corporation if the cash or other property used to purchase the stock or make the loans was from a source (a) covered by nonrecourse indebtedness (except for certain qualified nonrecourse financing, as defined in section 465(b)(6)); (b) protected against loss by a guarantee, stop-loss agreement, or other similar arrangement; or (c) that is covered by indebtedness from a person who has an interest in the activity or from a related person to a person (except you) having such an interest, other than a creditor.

- Any cash or property contributed to a corporate activity, or your interest in the corporate activity, that is (a) covered by nonrecourse indebtedness (except for certain qualified nonrecourse financing, as defined in section 465(b)(6)); (b) protected against loss by a guarantee, stop-loss agreement, or other similar arrangement; or (c) that is covered by indebtedness from a person who has an interest in such activity or from a related person to a person (except you) having such an interest, other than a creditor.

Any loss from a section 465 activity not allowed for this tax year will be treated as a deduction allocable to the activity in the next tax year.

You should get a separate statement of income, expenses, etc., for each activity from the corporation.

Passive Activity Limitations

Section 469 provides rules that limit the deduction of certain losses and credits. These rules apply to shareholders who:

- Are individuals, estates, or trusts and
- Have a passive activity loss or credit for the year.

Generally, passive activities include:

1. Trade or business activities in which you did not materially participate and
2. Activities that meet the definition of rental activities under Temporary Regulations section 1.469-1T(e)(3) and Regulations section 1.469-1(e)(3).

Passive activities do not include:

1. Trade or business activities in which you materially participated.
2. Rental real estate activities in which you materially participated if you were a “real estate professional” for the tax year. You were a real estate professional only if you met both of the following conditions:
 - a. More than half of the personal services you performed in trades or businesses were performed in real property trades or businesses in which you materially participated and
 - b. You performed more than 750 hours of services in real property trades or businesses in which you materially participated.

For purposes of this rule, each interest in rental real estate is a separate activity, unless you elect to treat all interests in rental real estate as one activity.

If you are married filing jointly, either you or your spouse must separately meet both of the above conditions, without taking into account services performed by the other spouse.

A real property trade or business is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Services you performed as an employee are not treated as performed in a real property trade or business unless you owned more than 5% of the stock (or more than 5% of the capital or profits interest) in the employer.

3. The rental of a dwelling unit any shareholder used for personal purposes during the year for more than the greater of 14 days or 10% of the number of days that the residence was rented at fair rental value.
4. Activities of trading personal property for the account of owners of interests in the activities.

If you have a passive activity loss or credit, see Form 8582, *Passive Activity Loss Limitations*, to figure your allowable passive losses, and Form 8582-CR, *Passive Activity Credit Limitations*, to figure your allowable passive credits.

If the corporation had more than one activity, it will attach a statement to your Schedule K-1 that identifies each activity (trade or business activity, rental real estate activity, rental activity other than rental real estate, etc.) and specifies the income (loss), deductions, and credits from each activity.

Material participation. You must determine if you materially participated (a) in each trade or business activity held through the corporation and (b), if you were a real estate professional (defined above), in each rental real estate activity held through the corporation. All determinations of material participation are made based on your participation during the corporation's tax year.

Material participation standards for shareholders who are individuals are listed below. Special rules apply to certain retired or disabled farmers and to the surviving spouses of farmers.

Individuals. If you are an individual, you materially participate in a trade or business activity only if one or more of the following apply:

1. You participated in the activity for more than 500 hours during the tax year.
2. Your participation in the activity for the tax year constituted substantially all of the participation in the activity of all individuals (including individuals who are not owners of interests in the activity).
3. You participated in the activity for more than 100 hours during the tax year, and your participation in the activity for the tax year was not less than the participation in the activity of any other individual (including individuals who were not owners of interests in the activity) for the tax year.
4. The activity was a significant participation activity for the tax year, and your aggregate participation in all significant participation activities (including those outside the corporation) during the tax year exceeded 500 hours. A significant participation activity is any trade or business activity in which you participated for more than 100 hours during the year and in which you did not materially participate under any of the material participation tests (other than this test).
5. You materially participated in the activity for any 5 tax years (whether or not consecutive) during the 10 tax years that immediately precede the tax year.

6. The activity was a personal service activity and you materially participated in the activity for any 3 tax years (whether or not consecutive) preceding the tax year. A personal service activity involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business, in which capital is not a material income-producing factor.
7. Based on all of the facts and circumstances, you participated in the activity on a regular, continuous, and substantial basis during the tax year.

Work counted toward material participation. Generally, any work that you or your spouse does in connection with an activity held through an S corporation (in which you own stock at the time the work is done) is counted toward material participation. However, work in connection with an activity is not counted toward material participation if either of the following applies:

1. The work is not the type of work that owners of the activity would usually do and one of the principal purposes of the work that you or your spouse does is to avoid the passive loss or credit limitations.
2. You do the work in your capacity as an investor and you are not directly involved in the day-to-day operations of the activity. Examples of work done as an investor that would not count toward material participation include:
 - a. Studying and reviewing financial statements or reports on operations of the activity,
 - b. Preparing or compiling summaries or analyses of the finances or operations of the activity for your own use, and
 - c. Monitoring the finances or operations of the activity in a nonmanagerial capacity.

Effect of determination. Income (loss), deductions, and credits from an activity are nonpassive if you determine that:

- You materially participated in a trade or business activity of the corporation, or
- You were a real estate professional in a rental real estate activity of the corporation.

If you determine that you did not materially participate in a trade or business activity of the corporation, or you have income (loss), deductions, or credits from a rental activity of the corporation (other than a rental real estate activity in which you materially participated, if you were a real estate professional), the amounts from that activity are passive. Report passive income (losses), deductions, and credits as follows:

1. If you have an overall gain (the excess of income over deductions and losses, including any prior year unallowed loss) from a passive activity, report the income, deductions, and losses from the activity as indicated in these instructions.
2. If you have an overall loss (the excess of deductions and losses, including any prior year unallowed loss, over income) or credits from a passive activity, you must report the income, deductions, losses, and credits from all passive activities using the Instructions for Form 8582 or Form 8582-CR, to see if your deductions, losses, and credits are limited under the passive activity rules.

Special allowance for a rental real estate activity. If you actively participated in a rental real estate activity, you may be able to deduct up to \$25,000 of the loss (or credit equivalent to a \$25,000 deduction) from the activity from nonpassive income. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities. The “special allowance” is not available if you were married, are filing a separate return for the year, and did not live apart from your spouse at all times during the year.

Only individuals and qualifying estates can actively participate in a rental real estate activity. However, a decedent’s estate (including a qualified revocable trust for which a section 645 election has been made) is treated as actively participating for its tax years ending less than 2 years after the decedent’s death, if the decedent would have satisfied the active participation requirement for the activity for the tax year the decedent died.

You are not considered to actively participate in a rental real estate activity if, at any time during the tax year, your interest (including your spouse’s interest) in the activity was less than 10% (by value) of all interests in the activity.

Active participation is a less stringent requirement than material participation. You may be treated as actively participating if you participated, for example, in making management decisions or arranging for others to provide services (such as repairs) in a significant and bona fide sense. Management decisions that can count as active participation include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions.

Modified adjusted gross income limitation. The maximum special allowance that single individuals and married individuals filing a joint return can qualify for is \$25,000. The maximum is \$12,500 for married individuals who file separate returns and who lived apart at all times during the year. The maximum special allowance for which an estate can qualify is \$25,000 reduced by the special allowance for which the surviving spouse qualifies.

If your modified adjusted gross income (defined below) is \$100,000 or less (\$50,000 or less if married filing separately), your loss is deductible up to the amount of the maximum special allowance referred to in the preceding paragraph. If your modified adjusted gross income is more than \$100,000 (more than \$50,000 if married filing separately), the special allowance is limited to 50% of the difference between \$150,000 (\$75,000 if married filing separately) and your modified adjusted gross income. When modified adjusted gross income is \$150,000 or more (\$75,000 or more if married filing separately), there is no special allowance.

Modified adjusted gross income is your adjusted gross income figured without taking into account:

- Any passive activity loss.
- Any rental real estate loss allowed under section 469(c)(7) to real estate professionals.
- Any overall loss from a publicly-traded partnership.
- Any taxable social security or equivalent railroad retirement benefits.

- Any deductible contributions to an IRA or certain other qualified retirement plans under section 219.
- The domestic production activities deduction.
- The student loan interest deduction.
- The tuition and fees deduction.
- The deduction for one-half of self-employment taxes.
- The exclusion from income of interest from Series EE or I U.S. Savings Bonds used to pay higher education expenses.
- The exclusion of amounts received under an employer's adoption assistance program.

Commercial revitalization deduction. The special \$25,000 allowance for the commercial revitalization deduction from rental real estate activities is not subject to the active participation rules or modified adjusted gross income limits discussed above. See the instructions for box 12, code N, for more information.

Special rules for certain other activities. If you have net income (loss), deductions, or credits from any activity to which special rules apply, the corporation will identify the activity and all amounts relating to it on Schedule K-1 or on an attachment.

If you have net income (loss), deductions, or credits from either of the following activities, treat such amounts as nonpassive and report them as instructed in these instructions:

1. The rental of a dwelling unit any shareholder used for personal purposes during the year for more than the greater of 14 days or 10% of the number of days that the residence was rented at fair rental value.
2. Trading personal property for the account of owners of interests in the activity.

Self-charged interest. The corporation will report any "self-charged" interest income or expense that resulted from loans between you and the corporation (or between the corporation and other S corporation or partnership in which you have an interest). If there was more than one activity, the corporation will provide a statement allocating the interest income or expense with respect to each activity. The self-charged interest rules do not apply to your interest in the S corporation if the corporation made an election under Regulations section 1.469-7(g) to avoid the application of these rules.

II. Specific Instructions

PART III. SHAREHOLDER'S SHARE OF CURRENT YEAR INCOME, DEDUCTIONS, CREDITS, AND OTHER ITEMS

The amounts shown in boxes 1 through 17 reflect your share of income, loss, deductions, credits, and other information from all corporate activities without reference to limitations on losses, credits, or other items that may have to be adjusted because of:

1. The adjusted basis of your stock and debt in the corporation,
2. The at-risk limitations,
3. The passive activity limitations, or
4. Any other limitations that must be taken into account at the shareholder level in figuring taxable income (e.g., the section 179 expense limitation).

For information on these provisions, see *Limitations on Losses, Deductions, and Credits*.

If you are an individual, and the above limitations do not apply to the amounts shown on your Schedule K-1, take the amounts shown and enter them on the lines of your tax return as indicated in the summarized reporting information of the Schedule K-1. If any of the above limitations apply, adjust the amounts on Schedule K-1 for the limitations before you report them on your return.

When applicable, the passive activity limitations on losses are applied after the limitations on losses for a shareholder's basis in stock and debt and the shareholder's at-risk amount.

The line numbers in the summarized reporting information of Schedule K-1 are references to forms in use for calendar year 2010. If you file your tax return on a calendar year basis, but the corporation files a return for a fiscal year, enter the amounts on your tax return for the year in which the corporation's fiscal year ends. For example, if the corporation's tax year ends in February 2011, report the amounts on your 2011 tax return.

If you have losses, deductions, credits, etc., from a prior year that were not deductible or usable because of certain limitations, such as the basis rules or the at-risk limitations, take them into account in determining your income, loss, etc., for this year. However, except for passive activity losses and credits, do not combine the prior-year amounts with any amounts shown on this Schedule K-1 to get a net figure to report on your return. Instead, report the amounts on your return on a year-by-year basis.

Caution. If you have amounts other than those shown on Schedule K-1 to report on Schedule E (Form 1040), enter each item separately on line 28 of Schedule E.

Codes. In box 10 and boxes 12 through 17, the corporation will identify each item by entering a code in the column to the left of the dollar amount entry space. These codes are identified on the back of Schedule K-1 and in these instructions.

Attached statements. The corporation will enter an asterisk (*) after the code, if any, in the column to the left of the dollar amount entry space for each item for which it has attached a statement providing additional information. For those informational items that cannot be reported as a single dollar amount, the corporation will enter an asterisk in the left column and enter "STMT" in the dollar amount entry space to indicate the information is provided on an attached statement.

INCOME (LOSS)

Box 1. Ordinary business income (loss)

The amount reported in box 1 is your share of the ordinary income (loss) from trade or business activities of the corporation. Generally, where you report this amount on Form 1040 depends on whether or not the amount is from an activity that is a passive activity to you. If you are an individual shareholder filing a 2010 Form 1040, find your situation below and report your box 1 income (loss) as instructed after applying the basis and at-

risk limitations on losses. If the corporation had more than one trade or business activity, it will attach a statement identifying the amount of income or loss from each activity.

1. Report box 1 income (loss) from trade or business activities in which you materially participated on Schedule E (Form 1040), line 28, column (h) or (j).
2. Report box 1 income (loss) from trade or business activities in which you did not materially participate, as follows:
 - a. If income is reported in box 1, report the income on Schedule E, line 28, column (g).
 - b. If a loss is reported in box 1, follow the Instructions for Form 8582 to determine how much of the loss can be reported on Schedule E, line 28, column (f).

Box 2. Net rental real estate income (loss)

Generally, the income (loss) reported in box 2 is a passive activity amount for all shareholders. However, the income (loss) in box 2 is not from a passive activity if you were a real estate professional and you materially participated in the activity. If the corporation had more than one rental real estate activity, it will attach a statement identifying the amount of income or loss from each activity.

If you are filing a 2010 Form 1040, use the following instructions to determine where to enter a box 2 amount:

1. If you have a loss from a passive activity in box 2 and you meet all of the following conditions, enter the loss on Schedule E (Form 1040), line 28, column (f):
 - a. You actively participated in the corporate rental real estate activities. (See *Special allowance for a rental real estate activity*.)
 - b. Rental real estate activities with active participation were your only passive activities.
 - c. You have no prior year unallowed losses from these activities.
 - d. Your total loss from the rental real estate activities was not more than \$25,000 (not more than \$12,500 if married filing separately and you lived apart from your spouse all year).
 - e. If you are a married person filing separately, you lived apart from your spouse all year.
 - f. You have no current or prior year unallowed credits from a passive activity.
 - g. Your modified adjusted gross income was not more than \$100,000 (not more than \$50,000 if married filing separately and you lived apart from your spouse all year).
2. If you have a loss from a passive activity in box 2 and you do not meet all of the conditions in 1 above, follow the Instructions for Form 8582 to determine how much of the loss can be reported on Schedule E (Form 1040), line 28, column (f).
3. If you were a real estate professional and you materially participated in the activity, report box 2 income (loss) on Schedule E, line 28, column (h) or (j).
4. If you have income from a passive activity in box 2, enter the income on Schedule E, line 28, column (g).

Box 3. Other net rental income (loss)

The amount in box 3 is a passive activity amount for all shareholders. If the corporation had more than one such rental activity, it will attach a statement identifying the amount of income or loss from each activity. Report the income or loss as follows:

1. If box 3 is a loss, follow the instructions for Form 8582 to figure how much of the loss can be reported on Schedule E, line 28, column (f).
2. If income is reported in box 3, report the income on Schedule E (Form 1040), line 28, column (g).

Portfolio income

Portfolio income or loss (shown in boxes 4 through 8b and in box 10, code A) is not subject to the passive activity limitations. Portfolio income includes income not derived in the ordinary course of a trade or business from interest, ordinary dividends, annuities, or royalties, and gain or loss on the sale of property that produces such income or is held for investment.

Box 4. Interest income.

Report taxable interest income on line 8a of Form 1040.

Box 5a. Ordinary dividends.

Report taxable ordinary dividends on line 9a of Form 1040.

Box 5b. Qualified dividends.

Report qualified dividends on line 9b of Form 1040.

Note: Qualified dividends are excluded from investment income, but you may elect to include part or all of these amounts in investment income. See the instructions for line 4g of Form 4952, Investment Interest Expense Deduction, for important information on making this election.

Box 6. Royalties.

Report royalties on Schedule E (Form 1040), line 4.

Box 7. Net short-term capital gain (loss).

Report the net short-term capital gain or (loss) on Schedule D (Form 1040), line 5.

Box 8a. Net long-term capital gain (loss)

Report the net long-term capital gain (loss) on Schedule D (Form 1040), line 12.

Box 8b. Collectibles (28%) gain (loss)

Report collectibles gain or loss on line 4 of the *28% Rate Gain worksheet – Line 18* in the instructions for Schedule D (Form 1040).

Box 8c. Unrecaptured section 1250 gain.

There are three types of unrecaptured section 1250 gain. Report your share of this unrecaptured gain on the *Unrecaptured Section 1250 Gain Worksheet – Line 19* in the instructions for Schedule D (Form 1040), as follows:

- Report unrecaptured section 1250 gain from the sale or exchange of the corporation's business assets on line 5.
- Report unrecaptured section 1250 gain from the sale or exchange of an interest in a partnership on line 10.
- Report unrecaptured section 1250 gain from an estate, trust, regulated investment company (RIC), or real estate investment trust (REIT) on line 11.

If the corporation reports only unrecaptured section 1250 gain from the sale or exchange of its business assets, it will enter a dollar amount in box 8c. If it reports the other two types of unrecaptured gain, it will provide an attached statement that shows the amount for each type of unrecaptured section 1250 gain.

Box 9. Net Section 1231 Gain (Loss)

The amount in box 9 is generally a passive activity amount if it is from a:

- Rental activity or
- Trade or business activity in which you did not materially participate.

However, an amount from a rental real estate activity is not from a passive activity if you were a real estate professional and you materially participated in the activity.

If the amount is either (a) a loss that is not from a passive activity or (b) a gain, report it on Form 4797, line 2, column (g). Do not complete columns (b) through (f) on line 2. Instead, enter "From Schedule K-1 (Form 1120S)" across these columns.

If the amount is a loss from a passive activity, see *Passive loss limitations* in the Instructions for Form 4797. Report the loss following the Instructions for Form 8582 to figure how much of the loss is allowed on Form 4797. If the corporation had net section 1231 gain (loss) from more than one activity, it will attach a statement that will identify the amount of section 1231 gain (loss) from each activity.

Box 10. Other income (loss)

Code A. Other portfolio income (loss). The corporation will report portfolio income, other than interest, ordinary dividend, royalty and capital gain (loss) income, and attach a statement to tell you what kind of portfolio income is reported.

If the corporation held a residual interest in a real estate mortgage investment conduit (REMIC), it will report on a statement your share of REMIC taxable income or (net loss)

that you report on Schedule E (Form 1040), line 38, column (d). The statement will also report your share of any “excess inclusion” that you report on Schedule E, line 38, column (c), and your share of section 212 expenses that you report on Schedule E, line 38, column (e). If you itemize your deductions on Schedule A (Form 1040), you may also deduct these section 212 expenses as a miscellaneous deduction subject to the 2% limit on Schedule A (Form 1040), line 23.

Code B. Involuntary conversions. This is your net loss from involuntary conversions due to casualty or theft. The corporation will give you a schedule that shows the amounts to be reported on Form 4684, Casualties and Thefts, line 37, columns (b)(i), (b)(ii) and (c).

If there was a gain (loss) from a casualty or theft to property not used in a trade or business or for income-producing purposes, the corporation will provide you with the information you need to complete Form 4684.

Code C. 1256 contracts & straddles. The corporation will report any net gain or loss from section 1256 contracts. Report this amount on Form 6781, Gains and Losses From Section 1256 Contracts and Straddles.

Code D. Mining exploration costs recapture. The corporation will give you a schedule that shows the information needed to recapture certain mining exploration costs (section 617).

Code E. Other income (loss). Amounts with code E are other items of income, gain, or loss not included in boxes 1 through 9 or in box 10 using codes A through D. The corporation should give you a description and the amount of your pro rata share for each of these items.

Report loss items that are passive activity amounts to you using the Instructions for Form 8582.

Code E items may include:

- Income from recoveries of tax benefit items. A tax benefit item is an amount you deducted in a prior tax year that reduced your income tax. Report this amount on Form 1040, line 21, to the extent it reduced your tax.
- Gambling gains and losses.
 1. If the corporation was not engaged in the trade or business of gambling, (a) report gambling winnings on Form 1040, line 21 and (b) deduct gambling losses to the extent of winnings on Schedule A (Form 1040), line 28.
 2. If the corporation was engaged in the trade or business of gambling, report gambling winnings on line 28 of Schedule E and (b) deduct gambling losses (to the extent of winnings) on line 28 of Schedule E, column (h).
- Gain (loss) from the disposition of an interest in oil, gas, geothermal, or other mineral properties. The corporation will give you an attached statement that provides a description of the property, your share of the amount realized from the disposition, your share of the corporation's adjusted basis in the property (for

other than oil or gas properties), and your share of the total intangible drilling costs, development costs, and mining exploration costs (section 59(e) expenditures) passed through for the property. You must figure your gain or loss from the disposition by increasing your share of the adjusted basis by the amount of intangible drilling costs, development costs, or mine exploration costs for the property that you capitalized (i.e., costs that you did not elect to deduct under section 59(e)). Report a loss in Part I of Form 4797. Report a gain in Part III of Form 4797 in accordance with the instructions for line 28. See Regulations section 1.1254-4 for details.

- Net short-term capital gain or loss and net long-term capital gain or loss from Schedule D (Form 1120S) that is not portfolio income (e.g., gain or loss from the disposition of nondepreciable personal property used in a trade or business activity of the corporation). Report total net short-term gain or loss on Schedule D (Form 1040), line 5. Report the total net long-term gain or loss on Schedule D (Form 1040), line 12.
- Current year section 108(i) cancellation of debt income. The corporation will provide your share of the deferred amount that you must include in income in the current tax year under section 108(i)(1) or section 108(i)(5)(D)(i) or (ii).
- Gain from the sale or exchange of qualified small business (QSB) stock (as defined in the Instructions for Schedule D (Form 1040)) that is eligible for the partial section 1202 exclusion. The corporation should also give you the name of the corporation that issued the QSB stock, your share of the corporation's adjusted basis and sales price of the QSB stock, and the dates the QSB stock was bought and sold. The following additional limitations apply at the shareholder level.
 1. You must have held an interest in the corporation when the corporation acquired the qualified small business stock and at all times thereafter until the corporation disposed of the qualified small business stock.
 2. Your share of the eligible section 1202 gain cannot exceed the amount that would have been allocated to you based on your interest in the corporation at the time the QSB stock was acquired.

See the Instructions for Schedule D (Form 1040) for details on how to report the gain and the amount of the allowable exclusion.

- Gain eligible for section 1045 rollover (replacement stock purchased by the corporation). The corporation should also give you the name of the corporation that issued the QSB stock, your share of the corporation's adjusted basis and sales price of the QSB stock, and the dates the QSB stock was bought and sold. To qualify for the section 1045 rollover:
 1. You must have held an interest in the corporation during the entire period in which the corporation held the qualified small business stock (more than 6 months prior to the sale) and
 2. Your share of the gain eligible for the section 1045 rollover cannot exceed the amount that would have been allocated to you based on your interest in the corporation at the time the QSB stock was acquired.

See the Instructions for Schedule D (Form 1040) for details on how to report the gain and the amount of the allowable postponed gain.

- Gain eligible for section 1045 rollover (replacement stock not purchased by the corporation). The corporation should also give you the name of the corporation that issued the QSB stock, your share of the corporation's adjusted basis and sales price of the QSB stock, and the dates the QSB stock was bought and sold. To qualify for the section 1045 rollover:
 1. You must have held an interest in the corporation during the entire period in which the corporation held the qualified small business stock (more than 6 months prior to the sale),
 2. Your share of the gain eligible for the section 1045 rollover cannot exceed the amount that would have been allocated to you based on your interest in the corporation at the time the stock was acquired, and
 3. You must purchase other qualified small business stock (as defined in the Instructions for Schedule D (Form 1040)) during the 60-day period that began on the date the QSB stock was sold by the corporation.

See the Instructions for Schedule D (Form 1040) for details on how to report the gain and the amount of the allowable postponed gain.

DEDUCTIONS

Box 11. Section 179 deduction

Use this amount, along with the total cost of section 179 property placed in service during the year from other sources, to complete Part I of Form 4562, Depreciation and Amortization. The corporation will report on an attached statement your share of the cost of any qualified enterprise zone, renewal community, qualified section 179 Recovery Assistance, qualified section 179 disaster assistance property, or qualified real property it placed in service during the tax year. Report the amount from line 12 of Form 4562 allocable to a passive activity using the Instructions for Form 8582. If the amount is not a passive activity deduction, report it on Schedule E (Form 1040), line 28, column (i).

Box 12. Other deductions

Contributions. Codes A through G. The corporation will give you a schedule that shows the charitable contributions subject to the 100%, 50%, 30%, and 20% adjusted gross income limitations.

If the corporation made a property contribution, it will report on an attached statement your share of both the fair market value and adjusted basis of the property. Use these amounts to adjust your stock basis. If the corporation made a qualified conservation contribution, it will report the fair market value of the underlying property before and after the donation, the type of legal interest contributed, and a description of the conservation purpose furthered by the donation. If the corporation made a contribution of real property located in a registered historic district, it will report any information you will need to take a deduction.

Charitable contribution deductions are not taken into account in figuring your passive activity loss for the year. Do not enter them on Form 8582.

Code A. Cash contributions (50%). Report this amount, subject to the 50% AGI limitation, on line 16 of Schedule A (Form 1040).

Code B. Cash contributions (30%). Report this amount, subject to the 30% AGI limitation, on line 16 of Schedule A (Form 1040).

Code C. Noncash contributions (50%). If property other than cash is contributed, and the claimed deduction for one item or group of similar items of property exceeds \$5,000, the corporation must give you a copy of Form 8283, Noncash Charitable Contributions, to attach to your tax return. Do not deduct the amount shown on Form 8283. It is the corporation's contribution. Instead, deduct the amount identified by code C, box 12, subject to the 50% AGI limitation, on line 17 of Schedule A (Form 1040).

If the corporation provides you with information that the contribution was property other than cash and does not give you a Form 8283, see the Instructions for Form 8283 for filing requirements. Do not file Form 8283 unless the total claimed deduction of all contributed items of property exceeds \$500.

Food inventory contributions. The corporation will report on an attached statement your share of qualified food inventory contributions. The food inventory contribution is not included in the amount reported in box 12 using code C. The corporation will also report your share of the corporation's net income from the business activities that made the food inventory contribution(s). Your deduction for food inventory contributions generally cannot exceed 10% of your aggregate net income for the tax year from the business activities from which the food inventory contribution was made (including your share of net income from partnership or S corporation businesses that made food inventory contributions). Report the deduction on line 17 of Schedule A (Form 1040).

Code D. Noncash contributions (30%). Report this amount, subject to the 30% AGI limitation, on line 17 of Schedule A (Form 1040).

Code E. Capital gain property to a 50% organization (30%). Report this amount, subject to the 30% AGI limitation, on line 17 of Schedule A (Form 1040). See *Special 30% Limit for Capital Gain Property* in Pub. 526.

Code F. Capital gain property (20%). Report this amount, subject to the 20% AGI limitation, on line 17 of Schedule A (Form 1040).

Code G. Contributions (100%). The corporation will report your share of qualified conservation contributions of property used in agriculture or livestock production. This contribution is not included in the amount reported in box 12 using code C. If you are a farmer or rancher, you qualify for a 100% AGI limitation for this contribution. Otherwise, your deduction for this contribution is subject to a 50% AGI limitation. Report this deduction on line 17 of Schedule A (Form 1040).

Code H. Investment Interest Expense. Enter this amount on Form 4952, line 1.

If the corporation has investment income or other investment expense, it will report your share of these items in box 17 using codes A and B. You will need to include investment income and expenses from all other sources to determine how much of your total investment interest is deductible.

Code I. Deductions – royalty income. Enter deductions allocable to royalties on Schedule E (Form 1040), line 18. For this type of expense, write “From Schedule K-1 (Form 1120S).”

These deductions are not taken into account in figuring your passive activity loss for the year. Do not enter them on Form 8582.

Code J. Section 59(e)(2) Expenditures. On an attached statement, the corporation will show the type and the amount of qualified expenditures for which you may make a section 59(e) election. The statement will also identify the property for which the expenditures were paid or incurred. If there is more than one type of expenditure, the amount of each type will be listed.

If you deduct these expenditures in full in the current year, they are treated as adjustments or tax preference items for purposes of alternative minimum tax. However, you may elect to amortize these expenditures over the number of years in the applicable period rather than deduct the full amount in the current year. If you make this election, these items are not treated as adjustments or tax preference items.

Under the election, you can deduct circulation expenditures ratably over a 3-year period. Research and experimental expenditures and mining exploration and development costs can be amortized over a 10-year period. Intangible drilling and development costs can be amortized over a 60-month period, beginning with the month in which such costs were paid or incurred.

Make the election on Form 4562. If you make the election, report the current year amortization of section 59(e) expenditures from Part VI of Form 4562 on line 28 of Schedule E (Form 1040). If you do not make the election, report the section 59(e)(2) expenditures on line 28 of Schedule E (Form 1040) and compute the resulting adjustment or tax preference item (see Form 6251, Alternative Minimum Tax – Individuals). Whether you deduct the expenditures or elect to amortize them, report the amount on a separate line in column (h) of line 28 if you materially participated in the partnership activity. If you did not materially participate, follow the Instructions for Form 8582 to figure how much of the deduction can be reported in column (f).

Code K. Deductions—portfolio (2% floor). Amounts with this code are deductions that are clearly and directly allocable to portfolio income (other than investment interest expense and section 212 expenses from a REMIC). Generally, you should enter these amounts on Schedule A (Form 1040), line 23. See the instructions for Schedule A, lines 23 and 28, for details.

These deductions are not taken into account in figuring your passive activity loss for the year. Do not enter them on Form 8582.

Code L. Deductions – portfolio (other). Generally, you should enter these amounts on Schedule A (Form 1040), line 28. See the instructions for Schedule A, lines 23 and 28, for details.

These deductions are not taken into account in figuring your passive activity loss for the year. Do not enter them on Form 8582.

Code M. Preproductive period expenses. You may be able to deduct these expenses currently or capitalize them under section 263A.

Code N. Commercial revitalization deduction from rental real estate activities. Follow the instructions for Form 8582 to determine how much of this deduction can be reported on Schedule E, line 28, column (f).

Code O. Reforestation expense deduction. The corporation will provide a statement that describes the qualified timber property for these reforestation expenses. Generally, the expense deduction is limited to \$10,000 (\$5,000 if married filing separately) for each qualified timber property, including your pro rata share of the corporation's expense and any reforestation expenses you separately paid or incurred during the tax year.

If you did not materially participate in the activity, use Form 8582 to figure the amount to report on Schedule E (Form 1040), line 28. If you materially participated in the reforestation activity, report the deduction on line 28, column (h), of Schedule E (Form 1040).

Code P. Domestic production activities information. The corporation will provide you with a statement with information that you must use to figure the domestic production activities deduction. Use Form 8903, Domestic Production Activities Deduction, to figure this deduction. For details, see the Instructions for Form 8903.

Code Q. Qualified production activities income (QPAI). Report the QPAI reported to you by the corporation (in box 12 of Schedule K-1) on line 7b of Form 8903. Report any portion of QPAI attributable to oil-related activities (identified on an attached statement) on line 7a.

Code R. Employer's W-2 wages. Report the portion of W-2 wages reported to you by the corporation (in box 12 of Schedule K-1) on line 17 of Form 8903.

Code S. Other deductions. Amounts with this code may include:

- Itemized deductions that Form 1040 filers enter on Schedule A (Form 1040).
- Soil and water conservation and endangered species recovery expenditures. See section 175 for limitations on the amount you are allowed to deduct.
- Expenditures for the removal of architectural and transportation barriers to the elderly and disabled that the corporation elected to treat as a current expense. The deductions are limited by section 190(c) to \$15,000 per year from all sources.

- Interest expense allocated to debt-financed distributions. The manner in which you report such interest expense depends on your use of the undistributed debt proceeds. If the proceeds were used in a trade or business activity, report the interest on line 28 of Schedule E (Form 1040). In column (a) enter the name of the corporation and “interest expense.” If you materially participated in the trade or business activity, enter the amount of interest expense in column (h). If you did not materially participate in the activity, follow the instructions for Form 8582 to determine the amount of interest expense you can report in column (f). If the proceeds were used in an investment activity, enter the interest on Form 4952. If the proceeds are used for personal purposes the interest is generally not deductible.
- Contributions to a capital construction fund (CCF). The deduction for a CCF investment is not taken on Schedule E (Form 1040). Instead, you subtract the deduction from the amount that would normally be entered as taxable income on line 43 (Form 1040). In the margin to the left of line 43, write “CCF” and the amount of the deduction.
- Penalty on early withdrawal of savings. Report this amount on Form 1040, line 30.
- Film and television production expenses. The corporation will provide a statement that describes the film or television production generating these expenses. Generally, if the aggregate cost of the production exceeds \$15 million, you are not entitled to the deduction. The limitation is \$20 million for productions in certain areas (see section 181 for details). If you did not materially participate in the activity, use Form 8582 to determine the amount that can be reported on Schedule E (Form 1040), line 28, column (f). If you materially participated in the production activity, report the deduction on Schedule E (Form 1040), line 28, column (h).
- Current year section 108(i) original issue discount deduction. The corporation will provide your share of the corporation’s original issue discount deduction deferred under section 108(i)(2)(A)(i) that is allowable as a deduction in the current tax year under section 108(i)(2)(A)(ii) or section 108(i)(5)(D)(i) or (ii).

The corporation will give you a description and the amount of your share of each of these items.

Box 13. Credits

If you have credits that are passive activity credits to you, you must complete Form 8582-CR in addition to the credit forms identified below. See *Passive Activity Limitations* and the Instructions for Form 8582-CR for details.

If the corporation is an eligible small business, the general business credits you receive from the corporation may be available to offset tentative minimum tax and qualify for a 5-year carryback. See the attachment for box 17, code U, to find out if the corporation is an eligible small business. For details, see the instructions for form 3800.

Tip. In general, shareholders whose only source for credits listed on Form 3800 are from pass-through entities are not required to complete the source credit form or attach it to Form 3800. Instead, you can report this credit directly on Form 3800. However, when applicable, all shareholders must complete and attach the following credit forms to Form 3800.

- Form 3468, Investment Credit (line 1a of Form 3800).
- Form 8864, Biodiesel and Renewable Diesel Fuels Credit (line 1l of Form 3800).

Codes A, B, C, and D. Low-income housing credit. If section 42(j)(5) applies, the corporation will report your share of the low-income housing credit using code A or code C, depending on the date the building was placed in service. If section 42(j)(5) does not apply, your share of the credit will be reported using code B or code D, depending on the date the building was placed in service. Any allowable low-income housing credit reported using code A or code B is reported on line 4 of Form 8586, Low-Income Housing Credit, or line 1d of Form 3800. Any allowable low-income housing credit reported using code C or code D is reported on line 11 of Form 8586.

Keep a separate record of the low-income housing credit from each separate source so that you can correctly figure any recapture of low-income housing credit that may result from the disposition of all or part of your stock in the corporation. For more information on recapture, see the instructions for Form 8611, Recapture of Low-Income Housing Credit.

Code E. Qualified rehabilitation expenditures (rental real estate). The corporation will report your share of the qualified rehabilitation expenditures and other information you need to complete Form 3468 related to rental real estate activities using code E. Your share of qualified rehabilitation expenditures from property not related to rental real estate activities will be reported in box 17 using code C. See the instructions for Form 3468 for details. If the corporation is reporting expenditures from more than one activity, the attached statement will separately identify the expenditures from each activity.

Combine the expenditures (for Form 3468 reporting) from box 13, code E, and from box 17, code C. The expenditures related to rental real estate activities (box 13, code E) are reported on Schedule K-1 separately from other qualified rehabilitation expenditures (box 17, code C) because they are subject to different passive activity limitation rules. See the Instructions for Form 8582-CR for details.

Code F. Other rental real estate credits. The corporation will identify the type of credit and any other information you need to compute credits from rental real estate activities (other than the low-income housing credit and qualified rehabilitation expenditures). These credits may be limited by the passive activity limitations. If the credits are from more than one activity, the corporation will identify the amount of credits from each activity on an attached statement.

Code G. Other rental credits. The corporation will identify the type of credit and any other information you need to compute these rental credits. These credits may be limited by the passive activity limitations. If the credits are from more than one activity, the corporation will identify the amount of credits from each activity on an attached statement.

Code H. Undistributed capital gains credit. Code H represents taxes paid on undistributed capital gains by a regulated investment company or real estate investment trust. Report these taxes on line 71 of Form 1040, check box 'a' for Form 2439, and add "Form 1120S." Reduce the basis of your stock by this tax.

Code I. Alcohol and cellulosic biofuel fuels credit. If this credit includes the small ethanol producer credit, the corporation will provide additional information on an attached statement. If no statement is attached, report this amount on line 8 of Form 6478, Alcohol and Cellulosic Biofuel Fuels Credit. If a statement is attached, see the instructions for Form 6478, line 8.

Code J. Work opportunity credit. Report this amount on line 3 of Form 5884, Work Opportunity Credit.

Code K. Disabled access credit. Report this amount on line 7 of Form 8826, Disabled Access Credit, or line 1e of Form 3800.

Code L. Empowerment zone and renewal community employment credit. Report this amount on line 3 of Form 8844, Empowerment Zone and Renewal Community Employment Credit.

Code M. Credit for increasing research activities. Report this amount on line 37 of Form 6765, Credit for Increasing Research Activities or line 1c of Form 3800.

Code N. Credit for employer social security and Medicare taxes. Report this amount on line 5 of Form 8846, Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips.

Code O. Backup withholding. This is your share of the credit for backup withholding on dividends, interest income, and other types of income. Include this amount in the total that you enter on Form 1040, line 61, and attach a copy of your Schedule K-1 to your tax return.

Code P. Other credits. On an attachment to Schedule K-1, the corporation will identify the type of credit and any other information you need to figure credits other than those reported with codes A through O. Most credits identified by code P will be reported on Form 3800.

Credits that may be reported with code P include the following:

- Unused investment credit from the qualifying advanced coal project credit, qualifying gasification project credit, qualifying advanced energy project credit, or qualified therapeutic discovery project credit allocated from cooperatives (Form 3468, line 9).
- Unused investment credit from the rehabilitation credit or energy credit allocated from cooperatives (Form 3468, line 13).
- Employee retention and employer housing credits for affected Midwestern disaster area employers (Form 3800, line 1t).
- New hire retention credit (Form 5884-B).
- Orphan drug credit (Form 8820).

- Qualified plug-in electric vehicle credit (Form 8834).
- Renewable electricity, refined coal, and Indian coal production credit. The corporation will provide a statement showing separately the amount of credit from Part I and Part II of Form 8835.
- Indian employment credit (Form 8845).
- Biodiesel and renewable diesel fuels credit. If this credit includes the small agri-biodiesel producer credit, the corporation will provide additional information on an attached statement. If no statement is attached, report this amount on line 9 of Form 8864. If a statement is attached, see the instructions for Form 8864, line 9.
- New markets credit (Form 8874).
- Credit for small employer pension plan startup costs (Form 8881).
- Credit for employer-provided childcare facilities and services (Form 8882).
- Low sulfur diesel fuel production credit (Form 8896).
- Qualified railroad track maintenance credit (Form 8900).
- Distilled spirits credit (Form 8906).
- Nonconventional source fuel credit (Form 8907).
- Energy efficient home credit (Form 8908).
- Energy efficient appliance credit (Form 8909).
- Alternative motor vehicle credit (Form 8910).
- Alternative fuel vehicle refueling property credit (Form 8911).
- Qualified zone academy bond credit. Report this amount on Form 8912.
- Clean renewable energy bond credit. Report this amount on Form 8912.
- New clean renewable energy bond credit. Report this amount on Form 8912.
- Qualified forestry conservation bond credit. Report this amount on Form 8912.
- Midwestern tax credit bond credit. Report this amount on Form 8912.
- Qualified energy conservation bond credit. Report this amount on Form 8912.
- Build America bond credit. Report this amount on Form 8912.
- Qualified school construction bond credit. Report this amount on Form 8912.
- Mine rescue team training credit (Form 8923).
- Agricultural chemicals security credit (Form 8931).
- Credit for employer differential wage payments (Form 8932).
- Carbon dioxide sequestration credit (Form 8933).
- Qualified plug-in electric drive motor vehicle credit (Form 8936).
- Credit for small employer health insurance premiums (Form 8941).
- General credits from an electing large partnership. Report these credits on Form 3800, line 1bb.

Box 14. Foreign Transactions

Codes A through N. Use the information identified by codes A through N, code Q, and any attached schedules to figure your foreign tax credit.

Codes O and P. Extraterritorial income exclusion.

1. *Corporation did not claim the exclusion.* If the corporation reports your pro rata share of foreign trading gross receipts (code O) and the extraterritorial income exclusion (code P), the corporation was not entitled to claim the exclusion because it did not meet the foreign economic process requirements. You may still qualify for your pro rata share of this exclusion if the corporation's foreign trading gross receipts for the tax year were \$5 million or less. To qualify for this

exclusion, your foreign trading gross receipts from all sources for the tax year also must have been \$5 million or less. If you qualify for the exclusion, report the exclusion amount in accordance with the instructions for boxes 1, 2, or 3, whichever applies. See Form 8873, Extraterritorial Income Exclusion, for more information.

2. *Corporation claimed the exclusion.* If the corporation reports your share of foreign trading gross receipts but not the amount of the extraterritorial income exclusion, the corporation met the foreign economic process requirements and claimed the exclusion when figuring your share of corporate income. You also may need to know your share of foreign trading gross receipts from this corporation to determine if you met the \$5 million or less exception discussed above for purposes of qualifying for an extraterritorial income exclusion from other sources.

Note. Upon request, the corporation should furnish you a copy of the corporation's Form 8873 if there is a reduction for international boycott operations, illegal bribes, kickbacks, etc.

Code Q. Other foreign transactions. On an attachment to Schedule K-1, the corporation will report any other information on foreign transactions that you may need using code Q.

Box 15. Alternative minimum tax (AMT) items

Use the information reported in box 15 (as well as adjustments and tax preference items from other sources) to prepare your Form 6251, Alternative Minimum Tax – Individuals, or Schedule I of Form 1041, Alternative Minimum Tax.

Code A. This amount is your share of the corporation's post-1986 depreciation adjustment. If you are an individual shareholder, report this amount on line 18 of Form 6251.

Code B. This amount is your share of the corporation's adjusted gain or loss. If you are an individual shareholder, report this amount on line 17 of Form 6251.

Code C. This amount is your share of the corporation's depletion adjustment. If you are an individual shareholder, report this amount on line 9 of Form 6251.

Codes D and E. Oil, gas, & geothermal properties – gross income and deductions. The amounts reported on these lines include only the gross income from, and deductions allocable to, oil, gas, and geothermal properties included in box 1 of Schedule K-1. The corporation should have attached a schedule that shows any income from or deductions allocable to such properties that are included in boxes 2 through 12, 16, and 17 of Schedule K-1. Use the amounts reported here and any other reported amounts to help you figure the net amount to enter on line 26 of Form 6251.

Code F. Other AMT Items. Enter the information on the statement attached by the corporation, along with items from other sources, on the applicable lines of Form 6251 or Schedule I of Form 1041.

Box 16. Items Affecting Shareholder Basis

Code A. Tax-exempt interest income. Report on your return, as an item of information, your share of the tax-exempt interest received or accrued by the corporation during the year. Individual shareholders include this amount on Form 1040, line 8b. Generally, you must increase the basis of your stock by this amount.

Code B. Other tax-exempt income. Generally, you must increase the basis of your stock by the amount shown, but do not include it in income on your tax return.

Code C. Nondeductible expenses. The nondeductible expenses paid or incurred by the corporation are not deductible on your tax return. Generally, you must decrease the basis of your stock by this amount.

Code D. Property distributions. Reduce the basis of your stock by distributions, not reported on form 1099-DIV, of property or money. This amount will include any amounts included in income with respect to new clean renewable energy, qualified energy conservation, qualified forestry conservation, qualified school construction, build America, or (for bonds issued after October 3, 2008) qualified zone academy bonds. If these distributions exceed the basis of your stock, the excess is treated as capital gain from the sale or exchange of property and is reported on Schedule D (Form 1040).

Code E. Repayment of loans from shareholders. If these payments are made on a loan with a reduced basis, the repayments must be allocated in part to a return of your basis in the loan and in part to the receipt of income. See Regulations section 1.1367-2 for information on reduction in basis of a loan and restoration in basis of a loan with a reduced basis.

Box 17. Other Information

Code A. Investment income. Report this amount on line 4a of Form 4952.

Code B. Investment expenses. Report this amount on line 5 of Form 4952.

Code C. Qualified rehabilitation expenditures (other than rental real estate). The corporation will report your share of qualified rehabilitation expenditures and other information you need to complete Form 3468 for property not related to rental real estate activities in box 17 using code C. Your share of qualified rehabilitation expenditures related to rental real estate activities is reported in box 13 using code E. See Form 3468 for details. If the corporation is reporting expenditures from more than one activity, the attached statement will separately identify the expenditures from each activity.

Combine the expenditures (for Form 3468 reporting) from box 13, code E and from box 17, code C. The expenditures related to rental real estate activities (box 13, code E) are reported on Schedule K-1 separately from other qualified rehabilitation expenditures (box 17, code C) because they are subject to different passive activity limitation rules. See the Instructions for Form 8582-CR for details.

Code D. Basis of energy property. If the corporation provides an attached statement for code D, use the information on the statement to complete lines 12a-d, 12f, 12g, 12i, 12j, 12l, 12m, 12, and 12q-12s of Form 3468.

Codes E and F. Recapture of low-income housing credit. The corporation will identify by code E your share of any recapture of a low-income housing credit from its investment in partnerships to which the provisions of section 42(j)(5) apply. All other recapture of low-income housing credits will be identified by code F.

Keep a separate record of each type of recapture so that you will be able to correctly figure any credit recapture that may result from the disposition of all or part of your corporate stock. For details, see Form 8611.

Code G. Recapture of investment credit. The corporation will provide any information you need to figure your recapture tax on Form 4255, Recapture of Investment Credit. See the Form 3468 on which you took the original credit for other information you need to complete Form 4255.

You may also need Form 4255 if your proportionate stock interest in the corporation is reduced by more than one-third after you were allocated part of an investment credit.

Code H. Recapture of other credits. On an attachment to Schedule K-1, the corporation will report any information you need to figure the recapture of other credits including the new markets credit, qualified plug-in electric vehicle credit, Indian employment credit, credit for employer-provided childcare facilities and services, alternative motor vehicle credit, alternative fuel vehicle refueling property credit, and qualified plug-in electric drive motor vehicle credit.

Code I. Look back interest – completed long-term contracts. The corporation will report any information you need to figure the interest due or to be refunded under the look-back method of section 460(b)(2) on certain long-term contracts. Use Form 8697, Interest Computation Under the Look-Back Method for Completed Long-Term Contracts, to report any such interest.

Code J. Look back interest – income forecast method. The corporation will report any information you need to figure the interest due or to be refunded under the look-back method of section 167(g)(2) for certain property placed in service after September 13, 1995, and depreciated under the income forecast method. Use Form 8866, Interest Computation Under the Look-Back Method for Property Depreciated Under the Income Forecast Method, to report any such interest.

Code K. Dispositions of property with section 179 deductions. The corporation will report your share of gain or loss on the sale, exchange, or other disposition of property for which a section 179 expense deduction was passed through to shareholders with code K. If the corporation passed through a section 179 deduction for the property, you must report the gain or loss and any recapture of the section 179 expense deduction for the property on your income tax return (see the instructions for Form 4797 for details). The corporation will provide all the following information.

1. Description of the property.
2. Date the property was acquired and placed in service.
3. Date of the sale or other disposition of the property.
4. Your share of the gross sales price or amount realized.
5. Your share of the cost or other basis plus the expense of sale.
6. Your share of the depreciation allowed or allowable.

7. Your share of the section 179 expense deduction (if any) passed through for the property and the corporation's tax year(s) in which the amount was passed through.

To figure the depreciation allowed or allowable for Form 4797, line 22, add to the amount from item 6 above the amount of your share of the section 179 expense deduction, reduced by any unused carryover of the deduction for this property. This amount may be different than the amount of section 179 expense you deducted for the property if your interest in the corporation has changed.

8. If the disposition is due to a casualty or theft, a statement providing the information you need to complete Form 4684.
9. If the sale was an installment sale made during the corporation's tax year, a statement providing the information you need to complete Form 6252, Installment Sale Income. The corporation will separately report your share of all payments received from the property in the following tax years. See the instructions for Form 6252 for details.

Code L. Recapture of section 179 deduction. The corporation will report your pro rata share of any recapture of section 179 expense deduction if business use of any property for which the section 179 expense deduction was passed through to shareholders dropped to 50 percent or less before the end of the recapture. If this occurs, the corporation must provide the following information.

1. Your share of the depreciation allowed or allowable (not including the section 179 expense deduction).
2. Your share of the section 179 expense deduction (if any) passed through for the property and the corporation's tax year(s) in which the amount was passed through. Reduce this amount by the portion, if any, of your unused (carryover) section 179 expense deduction for this property.

Code M. Section 453(l)(3) information. The corporation will report any information you need to figure the interest due under section 453(l)(3) with respect to the dispositions of certain timeshares and residential lots on the installment method. If you are an individual, report the interest on Form 1040, line 60. Enter "453(l)(3)" and the amount of the interest on the dotted line to the left of line 60.

Code N. Section 453A(c) information. The corporation will report any information you need to figure the interest due under section 453A(c) with respect to certain installment sales. If you are an individual, report the interest on Form 1040, line 60. Enter "453A(c)" and the amount of the interest on the dotted line to the left of line 60. See section 453A(c) for details on how to figure the interest.

Code O. Section 1260(b) information. The corporation will report any information you need to figure the interest due under section 1260(b). If the corporation had gain from certain constructive ownership transactions, your tax liability must be increased by the interest charge on any deferral of gain recognition under section 1260(b). Report the interest on Form 1040, line 60. Enter "1260(b)" and the amount of the interest on the dotted line to the left of line 60. See section 1260(b) for details, including how to figure the interest.

Code P. Interest allocable to production expenditures. The corporation will report any information you need relating to interest you are required to capitalize under section 263A for production expenditures. See Regulations sections 1.263A-8 through 1.263A-15 for details.

Code Q. CCF nonqualified withdrawal. The corporation will report your pro rata share of nonqualified withdrawals from a capital construction fund (CCF). These withdrawals are taxed separately from your other gross income at the highest marginal ordinary income or capital gains tax rate. Attach a statement to your Federal income tax return to show your computation of both the tax and interest for a nonqualified withdrawal. Include the tax and interest on Form 1040, line 60. To the left of line 60, enter the amount of tax and interest and "CCF."

Code R. Information needed to figure depletion-oil and gas. This is your share of gross income from the property, share of production for the tax year, etc., needed to figure your depletion deduction for oil and gas wells. The corporation should also allocate to you a proportionate share of the adjusted basis of each corporate oil or gas property. See Pub. 535 for how to figure your depletion deduction.

Reduce the basis of your stock by the amount of this deduction up to the extent of your adjusted basis in the property.

Code S. Amortization of reforestation costs. The corporation will provide a statement identifying your share of the amortizable basis of reforestation expenditures paid or incurred before October 23, 2004. The corporation will separately report your share of the amortizable basis of reforestation expenditures for 2003 and 2004. Your amortizable basis of reforestation expenditures for each tax year from all properties is limited to \$10,000 (\$5,000 if married filing separately), including your pro rata share of the corporation's expenditures and any qualified reforestation expenditures you separately paid or incurred. To figure your allowable amortization, see section 194 and Pub. 535.

Follow the instructions for Form 8582 to report a deduction allocable to a passive activity. If you materially participated in the reforestation activity, report the deduction on line 28, column (h), of Schedule E (Form 1040).

Code T. Section 108(i) information. If the corporation made a section 108(i) election, it will provide all the information you will need to determine your share of the following.

- Deferred cancellation of debt income.
- Deferred original issue discount deduction.

Code U. Other information The corporation will report:

1. Any information you need to complete a disclosure statement for reportable transactions in which the corporation participates. If the corporation participates in a transaction that must be disclosed on Form 8886, Reportable Transaction Disclosure Statement, both you and the corporation may be required to file Form 8886 for the transaction. The determination of whether you are required to disclose a transaction of the corporation is based on the category(s) under which the transaction qualifies for disclosure and is determined by the corporation. You may have to pay a penalty if you are required to file Form 8886 and do not do so. See the instructions for Form 8886 for details.

2. Gross farming and fishing income. If you are an individual shareholder, enter this income, as an item of information, on Schedule E (Form 1040), Part V, line 42. Do not report this income elsewhere on Form 1040.

For a shareholder that is an estate or trust, report this income to the beneficiaries, as an item of information, on Schedule K-1 (Form 1041). Do not report it elsewhere on Form 1041.

3. Excess farm loss limitation. If the corporation has deductions attributable to a farming activity, it will provide a statement showing the aggregate gross income or gain and the aggregate deductions from the farming activity that you need to figure any excess farm loss limitation. It will also provide information on any applicable subsidy it receives that would trigger the excess farm loss limitation.
4. The amount included in gross income with respect to qualified zone academy bonds issued before October 4, 2008. This amount cannot be used to increase your stock basis. Because this amount is already included in income elsewhere on Schedule K-1, you must reduce your stock basis by this amount.
5. The amount included in gross income with respect to clean renewable energy bonds. Income with respect to clean renewable energy bonds cannot be used to increase your stock basis. Because this amount is already included in income elsewhere on Schedule K-1, you must reduce your stock basis by this amount.
6. The amount included in gross income with respect to Midwestern tax credit bonds. Income with respect to Midwestern tax credit bonds cannot be used to increase your stock basis. Because this amount is already included in income elsewhere on Schedule K-1, you must reduce your stock basis by this amount.
7. Qualified investment in qualifying advanced coal project property. Use the amounts the corporation provides you to figure the amounts to report on Form 3468, lines 5a, 5b, and 5c.
8. Qualified investment in qualifying gasification property. Use the amounts the corporation provides you to figure the amounts to report on Form 3468, lines 6a and 6b.
9. Qualified investment in qualifying advanced energy project credit property. Use the amounts the corporation provides you to figure the amounts to report on Form 3468, line 7.
10. Qualified investment in a qualifying therapeutic discovery project. Use the amounts the corporation provides you to figure the amounts to report on Form 3468, line 8.
11. Eligible small business credits. General business credits attributable to an eligible small business may be used to offset tentative minimum tax and qualify for a 5-year carryback. An S corporation is an eligible small business if its average annual gross receipts for the three preceding tax years were \$50 million or less. For a credit received from the S corporation to qualify as an eligible small business credit, both you and the corporation must meet this gross receipts test. The corporation must tell you whether it qualifies as an eligible small business if it reports any general business credits on Schedule K-1. General business credits are reported using one or more of the following boxes on Schedule K-1.
 - Box 13.
 - Box 17 using code C or D.
 - Box 17 using Code U for items (7) through (10) above. For more information see the instructions for Form 3800.

12. Inversion gain. The corporation will provide a statement showing the amounts of each type of income or gain that is included in inversion gain. The corporation has included inversion gain in income elsewhere on Schedule K-1. Inversion gain is also reported under code U because your taxable income and alternative minimum taxable income cannot be less than the inversion gain. Also, your inversion gain: (a) is not taken into account in figuring the amount of net operating loss (NOL) for the tax year or the amount of NOL that can be carried over to each tax year, (b) may limit your credits, and (c) is treated as income from sources within the U.S. for the foreign tax credit. See section 7874 for details.
13. Any other information you may need to file with your individual tax return that is not shown elsewhere on Schedule K-1.

The corporation should give you a description and the amount of your share for each of these items.

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

2010

For calendar year 2010, or tax
year beginning _____, 2010
ending _____, 20____

Final K-1 Amended K-1

671110
OMB No. 1545-0130

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

Part I Information About the Corporation		Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items	
A Corporation's employer identification number		1 Ordinary business income (loss)	13 Credits
B Corporation's name, address, city, state, and ZIP code		2 Net rental real estate income (loss)	
C IRS Center where corporation filed return		3 Other net rental income (loss)	
Part II Information About the Shareholder		4 Interest income	
		5a Ordinary dividends	
		5b Qualified dividends	14 Foreign transactions
		6 Royalties	
		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)	
		10 Other income (loss)	15 Alternative minimum tax (AMT) items
F Shareholder's percentage of stock ownership for tax year _____ %			
For IRS Use Only		11 Section 179 deduction	16 Items affecting shareholder basis
		12 Other deductions	
			17 Other information
* See attached statement for additional information.			

For Paperwork Reduction Act Notice, see Instructions for Form 1120S.

Cat. No. 11520D

Schedule K-1 (Form 1120S) 2010

This list identifies the codes used on Schedule K-1 for all shareholders and provides summarized reporting information for shareholders who file Form 1040. For detailed reporting and filing information, see the separate Shareholder's Instructions for Schedule K-1 and the instructions for your income tax return.

	<i>Code</i>	<i>Report on</i>
1. Ordinary business income (loss). Determine whether the income (loss) is passive or nonpassive and enter on your return as follows:		
Passive loss	<i>Report on</i>	
Passive income	See the Shareholder's Instructions	
Nonpassive loss	Schedule E, line 28, column (g)	
Nonpassive income	Schedule E, line 28, column (j)	
2. Net rental real estate income (loss)	See the Shareholder's Instructions	
3. Other net rental income (loss)		
Net income	Schedule E, line 28, column (g)	
Net loss	See the Shareholder's Instructions	
4. Interest income	Form 1040, line 8a	
5a. Ordinary dividends	Form 1040, line 9a	
5b. Qualified dividends	Form 1040, line 9b	
6. Royalties	Schedule E, line 4	
7. Net short-term capital gain (loss)	Schedule D, line 5, column (f)	
8a. Net long-term capital gain (loss)	Schedule D, line 12, column (f)	
8b. Collectibles (28%) gain (loss)	28% Rate Gain Worksheet, line 4 (Schedule D instructions)	
8c. Unrecaptured section 1250 gain	See the Shareholder's Instructions	
9. Net section 1231 gain (loss)	See the Shareholder's Instructions	
10. Other income (loss)		
Code		
A Other portfolio income (loss)	See the Shareholder's Instructions	
B Involuntary conversions	See the Shareholder's Instructions	
C Sec. 1256 contracts & straddles	Form 6781, line 1	
D Mining exploration costs recapture	See Pub. 535	
E Other income (loss)	See the Shareholder's Instructions	
11. Section 179 deduction	See the Shareholder's Instructions	
12. Other deductions		
A Cash contributions (50%)	} See the Shareholder's Instructions	
B Cash contributions (30%)		
C Noncash contributions (50%)		
D Noncash contributions (30%)		
E Capital gain property to a 50% organization (30%)		
F Capital gain property (20%)		
G Contributions (100%)		
H Investment interest expense	Form 4952, line 1	
I Deductions—royalty income	Schedule E, line 18	
J Section 59(e)(2) expenditures	See the Shareholder's Instructions	
K Deductions—portfolio (2% floor)	Schedule A, line 23	
L Deductions—portfolio (other)	Schedule A, line 28	
M Preproductive period expenses	See the Shareholder's Instructions	
N Commercial revitalization deduction from rental real estate activities	See Form 8582 instructions	
O Reforestation expense deduction	See the Shareholder's Instructions	
P Domestic production activities information	See Form 8903 instructions	
Q Qualified production activities income	Form 8903, line 7b	
R Employer's Form W-2 wages	Form 8903, line 17	
S Other deductions	See the Shareholder's Instructions	
13. Credits		
A Low-income housing credit (section 42(j)(5)) from pre-2008 buildings	See the Shareholder's Instructions	
B Low-income housing credit (other) from pre-2008 buildings	See the Shareholder's Instructions	
C Low-income housing credit (section 42(j)(5)) from post-2007 buildings	Form 8586, line 11	
D Low-income housing credit (other) from post-2007 buildings	Form 8586, line 11	
E Qualified rehabilitation expenditures (rental real estate)	} See the Shareholder's Instructions	
F Other rental real estate credits		
G Other rental credits		
H Undistributed capital gains credit	Form 1040, line 71, box a	
I Alcohol and cellulosic biofuel fuels credit	Form 6478, line 8	
J Work opportunity credit	Form 5684, line 3	
K Disabled access credit	See the Shareholder's Instructions	
L Empowerment zone and renewal community employment credit	Form 8844, line 3	
M Credit for increasing research activities	See the Shareholder's Instructions	
N Credit for employer social security and Medicare taxes	Form 8846, line 5	
O Backup withholding	Form 1040, line 61	
P Other credits	See the Shareholder's Instructions	
14. Foreign transactions		
A Name of country or U.S. possession	} Form 1116, Part I	
B Gross income from all sources		
C Gross income sourced at shareholder level		
<i>Foreign gross income sourced at corporate level</i>		
D Passive category	} Form 1116, Part I	
E General category		
F Other		
<i>Deductions allocated and apportioned at shareholder level</i>		
G Interest expense	Form 1116, Part I	
H Other	Form 1116, Part I	
<i>Deductions allocated and apportioned at corporate level to foreign source income</i>		
I Passive category	} Form 1116, Part I	
J General category		
K Other		
<i>Other information</i>		
L Total foreign taxes paid	Form 1116, Part II	
M Total foreign taxes accrued	Form 1116, Part II	
N Reduction in taxes available for credit	Form 1116, line 12	
O Foreign trading gross receipts	Form 8873	
P Extraterritorial income exclusion	Form 8873	
Q Other foreign transactions	See the Shareholder's Instructions	
15. Alternative minimum tax (AMT) items		
A Post-1986 depreciation adjustment	} See the Shareholder's Instructions and the Instructions for Form 6251	
B Adjusted gain or loss		
C Depletion (other than oil & gas)		
D Oil, gas, & geothermal—gross income		
E Oil, gas, & geothermal—deductions		
F Other AMT items		
16. Items affecting shareholder basis		
A Tax-exempt interest income	Form 1040, line 8b	
B Other tax-exempt income	} See the Shareholder's Instructions	
C Nondeductible expenses		
D Distributions		
E Repayment of loans from shareholders		
17. Other information		
A Investment income	Form 4952, line 4a	
B Investment expenses	Form 4952, line 5	
C Qualified rehabilitation expenditures (other than rental real estate)	See the Shareholder's Instructions	
D Basis of energy property	See the Shareholder's Instructions	
E Recapture of low-income housing credit (section 42(j)(5))	Form 8611, line 8	
F Recapture of low-income housing credit (other)	Form 8611, line 8	
G Recapture of investment credit	See Form 4255	
H Recapture of other credits	See the Shareholder's Instructions	
I Look-back interest—completed long-term contracts	See Form 8697	
J Look-back interest—income forecast method	See Form 8866	
K Dispositions of property with section 179 deductions	} See the Shareholder's Instructions	
L Recapture of section 179 deduction		
M Section 453(f)(3) information		
N Section 453A(c) information		
O Section 1260(b) information		
P Interest allocable to production expenditures		
Q CCF nonqualified withdrawals		
R Depletion information—oil and gas		
S Amortization of reforestation costs		
T Section 108(j) information		
U Other information		

CHAPTER 2 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Generally, a corporation must file its income tax return by the 15th day of the 3rd month after the end of its tax year.
 - a) true
 - b) false

2. Which of the following is true regarding the accounting method used by a corporation:
 - a) a corporation must use the accrual method
 - b) the accounting method used must clearly show taxable income
 - c) the accounting method used must result in the higher taxable income
 - d) none of the above; there are not any accounting method requirements

3. Which of the following forms must a corporation generally file in order to change its tax year:
 - a) Form 1128
 - b) Form 3115
 - c) Form 4466
 - d) Form 7004

4. The gross rents entered on line 6, Gross Rents, should be reduced by expenses such as repairs, interest, taxes and depreciation.
 - a) true
 - b) false

5. The amount entered on line 12, Compensation of Officers, should include all officers' compensation.
 - a) true
 - b) false

6. When deducting interest expense:
- a) interest income should first be offset against the expense
 - b) a corporation must make an interest allocation if the proceeds of a loan were used for more than one purpose
 - c) all forms of interest expense are deductible
 - d) in no situations can amounts paid or credited to the accounts of depositors be deductible
7. Corporations can deduct membership dues for all of the following except:
- a) public service organizations
 - b) professional organizations
 - c) trade associations
 - d) airline clubs
8. If a corporation uses the cash method of accounting, it is required to use the lower of cost or market value to value inventory.
- a) true
 - b) false
9. A corporation whose total receipts and total assets at the end of the year are less than \$250,000 are required to complete:
- a) Schedule L
 - b) Schedule M-1
 - c) Schedule M-3
 - d) none of the above

CHAPTER 2 – SOLUTIONS AND SUGGESTED RESPONSES

1. **A: True is correct.** A new corporation filing a short-period return must generally file by the 15th day of the 3rd month after the short period ends.

B: False is incorrect. A corporation that has dissolved must generally file by the 15th day of the 3rd month after the date it dissolved.

(See page 2-2 of the course material.)

2. A: Incorrect. Although some corporations are required to use the accrual method of accounting, i.e., if the corporation has annual average gross receipts greater than \$5 million, not all corporations are required to use the accrual method.

B: Correct. Permissible methods include cash, accrual, or any other method authorized by the Internal Revenue Code.

C: Incorrect. There is no requirement that the accounting method that a corporation uses be the one that creates the largest tax liability.

D: Incorrect. A corporation should figure its taxable income using the method of accounting that is regularly used in keeping the corporation's books and records. There are a few requirements to the method used by a corporation depending on its size and type.

(See page 2-4 of the course material.)

3. **A: Correct.** Generally, a corporation must get the consent of the IRS before changing its tax year using Form 1128. There are some situations in which a corporation is not required to obtain IRS consent.

B: Incorrect. Form 3115 is used to apply for a change in accounting method.

C: Incorrect. Form 4466 is used to apply for a refund of an overpayment of estimated taxes.

D: Incorrect. Form 7004 is used to apply for an extension for filing a corporate income tax return.

(See page 2-4 of the course material.)

4. A: True is incorrect. The expenses for repairs, interest, taxes, and depreciation should be deducted on the proper lines for deductions.

B: False is correct. The gross amount should be recorded on line 6, without any of the mentioned deductions. A rental activity held by a closely held corporation or a personal service corporation may be subject to the passive activity loss rules.

(See page 2-6 of the course material.)

5. A: True is incorrect. Line 12 should only include deductible officers' compensation, and should not include compensation deductible elsewhere on the return, such as amounts included in cost of goods sold, elective contributions to a section 401(k) cash or deferred arrangement, or amounts contributed under a salary reduction SEP agreement or a SIMPLE IRA plan.

B: False is correct. Only the deductible portion of each officer's compensation should be included. Publicly held corporations cannot deduct compensation of a "covered employee" to the extent that it exceeds \$1 million.

(See page 2-11 of the course material.)

6. A: Incorrect. Interest income should not be offset against interest expense.

B: Correct. For instance, an allocation of the interest expense should be made if a loan were used to purchase a portfolio investment and to acquire an interest in a passive activity.

C: Incorrect. Some interest is not deductible, for instance interest and carrying charges on straddles. These amounts are generally required to be capitalized.

D: Incorrect. Mutual savings banks, building and loan associations, and cooperative banks can deduct the amounts paid or credited to the accounts of depositors as dividends, interest, or earnings.

(See pages 2-13 to 2-14 of the course material.)

7. A: Incorrect. Public service organizations dues are deductible.

B: Incorrect. Professional organization dues, such as bar and medical association dues, are deductible.

C: Incorrect. Trade association dues are deductible.

D: Correct. No deduction is allowed if a principal purpose of the organization is to entertain, or provide entertainment facilities for, members or their guests.

(See page 2-19 of the course material.)

8. A: True is incorrect. If the corporation is using the cash method of accounting, it is required to use the cost method to value inventory.

B: False is correct. The cost method is required if the cash method of accounting is used. Otherwise, cost, cost or market value (whichever is lower), or any other method approved by the IRS that conforms to the requirements of the applicable regulations can be used to value inventory.

(See page 2-25 of the course material.)

9. A: Incorrect. A corporation is not required to file Schedule L if their total receipts and total assets are less than \$250,000.

B: Incorrect. Schedule M-1 is not required if the corporation's total receipts and total assets are less than \$250,000.

C: Incorrect. Schedule M-3 is only required for corporations whose total assets are \$10 million or more.

D: Correct. Corporations whose total receipts and total assets are less than \$250,000 are not required to complete any of these schedules. Instead, they only need to enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the year on line 13 of Schedule K.

(See page 2-36 of the course material.)

Section 2

Partnerships

Chapter 3: Partnership General Tax Information

I. Introduction

This chapter explains how the income tax law applies to partnerships and to partners. Generally, a partnership does not pay tax on its income but “passes through” any profits or losses to its partners. Partners must include partnership items on their tax returns.

II. Important Issues

Withholding on foreign partner or firm. If a partnership acquires a U.S. real property interest from a foreign person or firm, the partnership may have to withhold tax on the amount it pays for the property (including cash, the fair market value of other property, and any assumed liability). If a partnership has income effectively connected with a trade or business in the United States, it **must** withhold on the income allocable to its foreign partners. A partnership may have to withhold tax on a foreign partner's distributive share of fixed or determinable income not effectively connected with a U.S. trade or business. A partnership that fails to withhold may be held liable for the tax, applicable penalties, and interest.

III. Forming A Partnership

The following sections contain general information about partnerships.

ORGANIZATIONS CLASSIFIED AS PARTNERSHIPS

An unincorporated organization with two or more members is generally classified as a partnership for federal tax purposes if its members carry on a trade, business, financial operation, or venture and divide its profits. However, a joint undertaking merely to share expenses is not a partnership. For example, co-ownership of property maintained and rented or leased is not a partnership unless the co-owners provide services to the tenants.

The rules you must use to determine whether an organization is classified as a partnership changed for organizations formed after 1996.

Organizations formed after 1996. An organization formed after 1996 is classified as a partnership for federal tax purposes if it has two or more members and it is none of the following.

- An organization formed under a federal or state law that refers to it as incorporated or as a corporation, body corporate, or body politic.
- An organization formed under a state law that refers to it as a joint-stock company or joint-stock association.
- An insurance company.
- Certain banks.
- An organization wholly owned by a state or local government.
- An organization specifically required to be taxed as a corporation by the Internal Revenue Code (for example, certain publicly traded partnerships).
- Certain foreign organizations.

- A tax-exempt organization.
- A real estate investment trust.
- An organization classified as a trust under section 301.7701-4 of the regulations or otherwise subject to special treatment under the Internal Revenue Code.
- Any other organization that elects to be classified as a corporation by filing Form 8832.

Limited liability company. A limited liability company (LLC) is an entity formed under state law by filing articles of organization as an LLC. Unlike a partnership, none of the members of an LLC are personally liable for its debts. An LLC may be classified for federal income tax purposes as either a partnership, a corporation, or an entity disregarded as an entity separate from its owner by applying the rules in regulations section 301.7701-3.

Tip. A domestic LLC with at least two members that does not file Form 8832 is classified as a partnership for federal income tax purposes.

Organizations formed before 1997. An organization formed before 1997 and classified as a partnership under the old rules will generally continue to be classified as a partnership as long as the organization has at least two members and does not elect to be classified as a corporation by filing Form 8832.

Community property. A husband and wife who own a qualified entity (defined later) can choose to classify the entity as a partnership for federal tax purposes by filing the appropriate partnership tax returns. They can choose to classify the entity as a sole proprietorship by filing a Schedule C (Form 1040) listing one spouse as the sole proprietor. A change in reporting position will be treated for federal tax purposes as a conversion of the entity.

A **qualified entity** is a business entity that meets all the following requirements.

- The business entity is wholly owned by a husband and wife as community property under the laws of a state, a foreign country, or a possession of the United States.
- No person other than one or both spouses would be considered an owner for federal tax purposes.
- The business entity is not treated as a corporation.

FAMILY PARTNERSHIP

Members of a family can be partners. However, family members (or any other person) will be recognized as partners only if one of the following requirements is met.

- If capital is a material income-producing factor, they acquired their capital interest in a bona fide transaction (even if by gift or purchase from another family member), actually own the partnership interest, and actually control the interest.
- If capital is not a material income-producing factor, they joined together in good faith to conduct a business. They agreed that contributions of each entitle them to a share in the profits, and some capital or service has been (or is) provided by each partner.

Capital is material. Capital is a material income-producing factor if a substantial part of the gross income of the business comes from the use of capital. Capital is ordinarily an income-producing factor if the operation of the business requires substantial inventories or investments in plants, machinery, or equipment.

Capital is not material. In general, capital is not a material income-producing factor if the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership.

Capital interest. A capital interest in a partnership is an interest in its assets that is distributable to the owner of the interest in either of the following situations.

- The owner withdraws from the partnership.
- The partnership liquidates.

The mere right to share in earnings and profits is not a capital interest in the partnership.

Gift of capital interest. If a family member (or any other person) receives a gift of a capital interest in a partnership in which capital is a material income-producing factor, the donee's distributive share of partnership income is subject to both of the following restrictions.

- It must be figured by reducing the partnership income by reasonable compensation for services the donor renders to the partnership.
- The donee's distributive share of partnership income attributable to donated capital must not be proportionately greater than the donor's distributive share attributable to the donor's capital.

Purchase. For purposes of determining a partner's distributive share, an interest purchased by one family member from another family member is considered a gift from the seller. The fair market value of the purchased interest is considered donated capital. For this purpose, members of a family include only spouses, ancestors, and lineal descendants (or a trust for the primary benefit of those persons).

Example. A father sold 50% of his business to his son. The resulting partnership had a profit of \$60,000. Capital is a material income-producing factor. The father performed services worth \$24,000, which is reasonable compensation, and the son performed no services. The \$24,000 must be allocated to the father as compensation. Of the remaining \$36,000 of profit due to capital, at least 50%, or \$18,000, must be allocated to the father since he owns a 50% capital interest. The son's share of partnership profit cannot be more than \$18,000.

Husband-wife partnership. If spouses carry on a business together and share in the profits and losses, they may be partners whether or not they have a formal partnership agreement. If so, they should report income or loss from the business on Form 1065. They should **not** report the income on a Schedule C (Form 1040) in the name of one spouse as a sole proprietor. However, the husband and wife can elect not to treat the joint venture as a partnership if they meet each of the following requirements.

- The only members of the joint venture are the husband and wife.
- The filing status of the husband and wife is married filing jointly.
- Both spouses materially participate in the trade or business (see Passive Activity Limitations in the Instructions for Form 1065 for a definition of material participation).
- Both spouses elect this treatment.

If both spouses elect this treatment, all income, gains, losses, deductions, and credits are divided based on each spouse's interest in the joint venture and both are treated as sole proprietors for both income and self-employment tax.

If the husband and wife do not make the election to treat their joint venture as sole proprietorships, each spouse should carry his or her share of the partnership income or loss from Schedule K-1 (Form 1065) to their joint or separate Form(s) 1040. Each spouse should include his or her respective share of self-employment income on a separate Schedule SE (Form 1040), Self-Employment Tax. This generally does not increase the total tax on the return, but it does give each spouse credit for social security earnings on which retirement benefits are based.

PARTNERSHIP AGREEMENT

The partnership agreement includes the original agreement and any modifications. The modifications must be agreed to by all partners or adopted in any other manner provided by the partnership agreement. The agreement or modifications can be oral or written.

Partners can modify the partnership agreement for a particular tax year after the close of the year but not later than the date for filing the partnership return for that year. This filing date does not include any extension of time.

If the partnership agreement or any modification is silent on any matter, the provisions of local law are treated as part of the agreement.

IV. Terminating a Partnership

A partnership terminates when one of the following events takes place.

1. All its operations are discontinued and no part of any business, financial operation, or venture is continued by any of its partners in a partnership.
2. At least 50% of the total interest in partnership capital and profits is sold or exchanged within a 12-month period, including a sale or exchange to another partner.

Unlike other partnerships, an electing large partnership does not terminate on the sale or exchange of 50% or more of the partnership interests within a 12-month period.

See section 1.708-1(b) of the regulations for more information on the termination of a partnership. For special rules that apply to a merger, consolidation, or division of a partnership, see sections 1.708-1(c) and 1.708-1(d) of the regulations.

Date of termination. The partnership's tax year ends on the date of termination. For the event described in (1), earlier, the date of termination is the date the partnership completes the winding up of its affairs. For the event described in (2), earlier, the date of termination is the date of the sale or exchange of a partnership interest that, by itself or together with other sales or exchanges in the preceding 12 months, transfers an interest of 50% or more in both capital and profits.

Short period return. If a partnership is terminated before the end of the tax year, Form 1065 must be filed for the short period, which is the period from the beginning of the tax year through the date of termination. The return is due the 15th day of the fourth month following the date of termination.

Conversion of partnership into limited liability company (LLC). The conversion of a partnership into an LLC classified as a partnership for federal tax purposes does not terminate the partnership. The conversion is not a sale, exchange, or liquidation of any partnership interest, the partnership's tax year does not close, and the LLC can continue to use the partnership's taxpayer identification number.

However, the conversion may change some of the partners' bases in their partnership interests if the partnership has recourse liabilities that become nonrecourse liabilities. Because the partners share recourse and nonrecourse liabilities differently, their bases must be adjusted to reflect the new sharing ratios. If a decrease in a partner's share of liabilities exceeds the partner's basis, he or she must recognize gain on the excess. For more information, see *Effect of Partnership Liabilities* under *Basis of Partner's Interest*, later.

The same rules apply if an LLC classified as a partnership is converted into a partnership.

IRS E-FILE (ELECTRONIC FILING)

Certain partnerships with more than 100 partners are required to file Form 1065, Schedules K-1, and related forms and schedules electronically (*e-file*). Other partnerships generally have the option to file electronically. For details about IRS *e-file*, see the Form 1065 instructions.

V. Exclusion From Partnership Rules

Certain partnerships that do not actively conduct a business can choose to be completely or partially excluded from being treated as partnerships for federal income tax purposes. All the partners must agree to make the choice, and the partners must be able to compute their own taxable income without computing the partnership's income. However, the partners are not exempt from the rule that limits a partner's distributive share of partnership loss to the adjusted basis of the partner's partnership interest. Nor are they exempt from the requirement of a business purpose for adopting a tax year for the partnership that differs from its required tax year.

Investing partnership. An investing partnership can be excluded if the participants in the joint purchase, retention, sale, or exchange of investment property meet all the following requirements.

- They own the property as co-owners.
- They reserve the right separately to take or dispose of their shares of any property acquired or retained.
- They do not actively conduct business or irrevocably authorize some person acting in a representative capacity to purchase, sell, or exchange the investment property. Each separate participant can delegate authority to purchase, sell, or exchange his or her share of the investment property for the time being for his or her account, but not for a period of more than a year.

Operating agreement partnership. An operating agreement partnership group can be excluded if the participants in the joint production, extraction, or use of property meet all the following requirements.

- They own the property as co-owners, either in fee or under lease or other form of contract granting exclusive operating rights.
- They reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used.
- They do not jointly sell services or the property produced or extracted. Each separate participant can delegate authority to sell his or her share of the property produced or extracted for the time being for his or her account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than one year.

However, this exclusion does not apply to an unincorporated organization one of whose principal purposes is cycling, manufacturing, or processing for persons who are not members of the organization.

Electing the exclusion. An eligible organization that wishes to be excluded from the partnership rules must make the election not later than the time for filing the partnership return for the first tax year for which exclusion is desired. This filing date includes any extension of time. See section 1.761-2(b) of the regulations for the procedures to follow.

VI. Partnership Return (Form 1065)

Every partnership that engages in a trade or business or has gross income must file an information return on Form 1065 showing its income, deductions, and other required information. The partnership return must show the names and addresses of each partner and each partner's distributive share of taxable income. The return must be signed by a general partner. If a limited liability company is treated as a partnership, it must file Form 1065 and one of its members must sign the return.

A partnership is not considered to engage in a trade or business, and is not required to file a Form 1065, for any tax year in which it neither receives income nor pays or incurs any expenses treated as deductions or credits for federal income tax purposes.

See the instructions for Form 1065 for more information about who must file Form 1065.

VII. Partnership Distributions

Partnership distributions include the following.

- A withdrawal by a partner in anticipation of the current year's earnings.
- A distribution of the current year's or prior years' earnings not needed for working capital.
- A complete or partial liquidation of a partner's interest.
- A distribution to all partners in a complete liquidation of the partnership.

A partnership distribution is not taken into account in determining the partner's distributive share of partnership income or loss. If any gain or loss from the distribution is recognized by the partner, it must be reported on his or her return for the tax year in which the distribution is received. Money or property withdrawn by a partner in anticipation of the current year's earnings is treated as a distribution received on the last day of the partnership's tax year.

Effect on partner's basis. A partner's adjusted basis in his or her partnership interest is decreased (but not below zero) by the money and adjusted basis of property distributed to the partner. See *Adjusted Basis* under *Basis of Partner's Interest*, later.

Effect on partnership. A partnership generally does not recognize any gain or loss because of distributions it makes to partners. The partnership may be able to elect to adjust the basis of its undistributed property.

Certain distributions treated as a sale or exchange. When a partnership distributes the following items, the distribution may be treated as a sale or exchange of property rather than a distribution.

- Unrealized receivables or substantially appreciated inventory items distributed in exchange for any part of the partner's interest in other partnership property, including money.
- Other property (including money) distributed in exchange for any part of a partner's interest in unrealized receivables or substantially appreciated inventory items.

See *Payments for Unrealized Receivables and Inventory Items* under *Disposition of Partner's Interest*, later.

This treatment does not apply to the following distributions.

- A distribution of property to the partner who contributed the property to the partnership.
- Payments made to a retiring partner or successor in interest of a deceased partner that are the partner's distributive share of partnership income or guaranteed payments.

Substantially appreciated inventory items. Inventory items of the partnership are considered to have appreciated substantially in value if, at the time of the distribution, their total fair market value is more than 120% of the partnership's adjusted basis for the property. However, if a principal purpose for acquiring inventory property is to avoid ordinary income treatment by reducing the appreciation to less than 120%, that property is excluded.

PARTNER'S GAIN OR LOSS

A partner generally recognizes gain on a partnership distribution only to the extent any money (and marketable securities treated as money) included in the distribution exceeds the adjusted basis of the partner's interest in the partnership. Any gain recognized is generally treated as capital gain from the sale of the partnership interest on the date of the distribution. If partnership property (other than marketable securities treated as money) is distributed to a partner, he or she generally does not recognize any gain until the sale or other disposition of the property.

For exceptions to these rules, see *Distribution of partner's debt* and *Net precontribution gain*, later. Also, see *Payments for Unrealized Receivables and Inventory Items* under *Disposition of Partner's Interest*, later.

Example. The adjusted basis of Jo's partnership interest is \$14,000. She receives a distribution of \$8,000 cash and land that has an adjusted basis of \$2,000 and a fair market value of \$3,000. Because the cash received does not exceed the basis of her partnership interest, Jo does not recognize any gain on the distribution. Any gain on the land will be recognized when she sells or otherwise disposes of it. The distribution decreases the adjusted basis of Jo's partnership interest to \$4,000 [$\$14,000 - (\$8,000 + \$2,000)$].

Marketable securities treated as money. Generally, a marketable security distributed to a partner is treated as money in determining whether gain is recognized on the distribution. This treatment, however, does not generally apply if that partner contributed the security to the partnership or an investment partnership made the distribution to an eligible partner.

The amount treated as money is the security's fair market value when distributed, reduced (but not below zero) by the excess (if any) of:

1. The partner's distributive share of the gain that would be recognized had the partnership sold all its marketable securities at their fair market value immediately before the transaction resulting in the distribution, over
2. The partner's distributive share of the gain that would be recognized had the partnership sold all such securities it still held after the distribution at the fair market value in (1).

For more information, including the definition of marketable securities, see section 731(c) of the Internal Revenue Code.

Loss on distribution. A partner does not recognize loss on a partnership distribution unless all the following requirements are met.

- The adjusted basis of the partner's interest in the partnership exceeds the distribution.
- The partner's entire interest in the partnership is liquidated.
- The distribution is in money, unrealized receivables, or inventory items.

There are exceptions to these general rules. See the following discussions. Also, see *Liquidation at Partner's Retirement or Death* under *Disposition of Partner's Interest*, later.

Distribution of partner's debt. If a partnership acquires a partner's debt and extinguishes the debt by distributing it to the partner, the partner will recognize capital gain or loss to the extent the fair market value of the debt differs from the basis of the debt (determined under the rules discussed in *Partner's Basis for Distributed Property*, later).

The partner is treated as having satisfied the debt for its fair market value. If the issue price (adjusted for any premium or discount) of the debt exceeds its fair market value when distributed, the partner may have to include the excess amount in income as canceled debt.

Similarly, a deduction may be available to a corporate partner if the fair market value of the debt at the time of distribution exceeds its adjusted issue price.

Net precontribution gain. A partner generally must recognize gain on the distribution of property (other than money) if the partner contributed appreciated property to the partnership during the 7-year period before the distribution.

Caution. A 5-year period applies to property contributed before June 9, 1997, or under a written binding contract:

1. That was in effect on June 8, 1997, and at all times thereafter before the contribution, and
2. That provides for the contribution of a fixed amount of property.

The gain recognized is the lesser of the following amounts.

1. The excess of:
 - a. The fair market value of the property received in the distribution, over
 - b. The adjusted basis of the partner's interest in the partnership immediately before the distribution, reduced (but not below zero) by any money received in the distribution.
2. The "net precontribution gain" of the partner. This is the net gain the partner would recognize if all the property contributed by the partner within 7 years (5 years for property contributed before June 9, 1997) of the distribution, and held by the partnership immediately before the distribution, were distributed to another partner, other than a partner who owns more than 50% of the partnership. For information about the distribution of contributed property to another partner, see *Contribution of Property*, under *Transactions Between Partnership and Partners*, later.

The character of the gain is determined by reference to the character of the net precontribution gain. This gain is in addition to any gain the partner must recognize if the money distributed is more than his or her basis in the partnership.

For these rules, the term "money" includes marketable securities treated as money, as discussed earlier.

Effect on basis. The adjusted basis of the partner's interest in the partnership is increased by any net precontribution gain recognized by the partner. Other than for purposes of determining the gain, the increase is treated as occurring immediately before the distribution. See *Basis of Partner's Interest*, later.

The partnership must adjust its basis in any property the partner contributed within 7 years (5 years for property contributed before June 9, 1997) of the distribution to reflect any gain that partner recognizes under this rule.

Exceptions. Any part of a distribution that is property the partner previously contributed to the partnership is not taken into account in determining the amount of the excess distribution or the partner's net precontribution gain. For this purpose, the partner's previously contributed property does not include a contributed interest in an entity to the extent its value is due to property contributed to the entity after the interest was contributed to the partnership.

Recognition of gain under this rule also does not apply to a distribution of unrealized receivables or substantially appreciated inventory items if the distribution is treated as a sale or exchange, as discussed earlier.

PARTNER'S BASIS FOR DISTRIBUTED PROPERTY

Unless there is a complete liquidation of a partner's interest, the basis of property (other than money) distributed to the partner by a partnership is its adjusted basis to the partnership immediately before the distribution. However, the basis of the property to the partner cannot be more than the adjusted basis of his or her interest in the partnership reduced by any money received in the same transaction.

Example 1. The adjusted basis of Beth's partnership interest is \$30,000. She receives a distribution of property that has an adjusted basis of \$20,000 to the partnership and \$4,000 in cash. Her basis for the property is \$20,000.

Example 2. The adjusted basis of Mike's partnership interest is \$10,000. He receives a distribution of \$4,000 cash and property that has an adjusted basis to the partnership of \$8,000. His basis for the distributed property is limited to \$6,000 (\$10,000 - \$4,000, the cash he receives).

Complete liquidation of partner's interest. The basis of property received in complete liquidation of a partner's interest is the adjusted basis of the partner's interest in the partnership reduced by any money distributed to the partner in the same transaction.

Partner's holding period. A partner's holding period for property distributed to the partner includes the period the property was held by the partnership. If the property was contributed to the partnership by a partner, then the period it was held by that partner is also included.

Basis divided among properties. If the basis of property received is the adjusted basis of the partner's interest in the partnership (reduced by money received in the same transaction), it must be divided among the properties distributed to the partner. For property distributed after August 5, 1997, allocate the basis using the following rules.

1. Allocate the basis first to unrealized receivables and inventory items included in the distribution by assigning a basis to each item equal to the partnership's adjusted basis in the item immediately before the distribution. If the total of these assigned bases exceeds the allocable basis, decrease the assigned bases by the amount of the excess.
2. Allocate any remaining basis to properties other than unrealized receivables and inventory items by assigning a basis to each property equal to the partnership's adjusted basis in the property immediately before the distribution. If the allocable basis exceeds the total of these assigned bases, increase the assigned bases by the amount of the excess. If the total of these assigned bases exceeds the allocable basis, decrease the assigned bases by the amount of the excess.

Allocating a basis increase. Allocate any basis increase required in rule (2), above, first to properties with unrealized appreciation to the extent of the unrealized appreciation. (If the basis increase is less than the total unrealized appreciation, allocate it among those properties in proportion to their respective amounts of unrealized appreciation.) Allocate any remaining basis increase among all the properties in proportion to their respective fair market values.

Example. Julie's basis in her partnership interest is \$55,000. In a distribution in liquidation of her entire interest, she receives properties A and B, neither of which is inventory or unrealized receivables. Property A has an adjusted basis to the partnership of \$5,000 and a fair market value of \$40,000. Property B has an adjusted basis to the partnership of \$10,000 and a fair market value of \$10,000.

To figure her basis in each property, Julie first assigns bases of \$5,000 to property A and \$10,000 to property B (their adjusted bases to the partnership). This leaves a \$40,000 basis increase (the \$55,000 allocable basis minus the \$15,000 total of the assigned bases). She first allocates \$35,000 to property A (its unrealized appreciation). The remaining \$5,000 is allocated between the properties based on their fair market values. \$4,000 ($\$40,000/\$50,000$) is allocated to property A and \$1,000 ($\$10,000/\$50,000$) is allocated to property B. Julie's basis in property A is \$44,000 ($\$5,000 + \$35,000 + \$4,000$) and her basis in property B is \$11,000 ($\$10,000 + \$1,000$).

Allocating a basis decrease. Use the following rules to allocate any basis decrease required in rule (1) or rule (2), earlier.

1. Allocate the basis decrease first to items with unrealized depreciation to the extent of the unrealized depreciation. (If the basis decrease is less than the total unrealized depreciation, allocate it among those items in proportion to their respective amounts of unrealized depreciation.)
2. Allocate any remaining basis decrease among all the items in proportion to their respective assigned basis amounts (as decreased in (1)).

Example. Tom's basis in his partnership interest is \$20,000. In a distribution in liquidation of his entire interest, he receives properties C and D, neither of which is inventory or unrealized receivables. Property C has an adjusted basis to the partnership of \$15,000 and a fair market value of \$15,000. Property D has an adjusted basis to the partnership of \$15,000 and a fair market value of \$5,000.

To figure his basis in each property, Tom first assigns bases of \$15,000 to property C and \$15,000 to property D (their adjusted bases to the partnership). This leaves a \$10,000 basis decrease (the \$30,000 total of the assigned bases minus the \$20,000 allocable basis). He allocates the entire \$10,000 to property D (its unrealized depreciation). Tom's basis in property C is \$15,000 and his basis in property D is \$5,000 (\$15,000 - \$10,000).

Distributions before August 6, 1997. For property distributed before August 6, 1997, allocate the basis using the following rules.

1. Allocate the basis first to unrealized receivables and inventory items included in the distribution to the extent of the partnership's adjusted basis in those items. If the partnership's adjusted basis in those items exceeded the allocable basis, allocate the basis among the items in proportion to their adjusted bases to the partnership.
2. Allocate any remaining basis to other distributed properties in proportion to their adjusted bases to the partnership.

Partner's interest more than partnership basis. If the basis of a partner's interest to be divided in a complete liquidation of the partner's interest is more than the partnership's adjusted basis for the unrealized receivables and inventory items distributed, and if no other property is distributed to which the partner can apply the remaining basis, the partner has a capital loss to the extent of the remaining basis of the partnership interest.

Special adjustment to basis. A partner who acquired any part of his or her partnership interest in a sale or exchange or upon the death of another partner may be able to choose a special basis adjustment for property distributed by the partnership. To choose the special adjustment, the partner must have received the distribution within 2 years after acquiring the partnership interest. Also, the partnership must not have chosen the optional adjustment to basis when the partner acquired the partnership interest.

If a partner chooses this special basis adjustment, the partner's basis for the property distributed is the same as it would have been if the partnership had chosen the optional adjustment to basis. However, this assigned basis is not reduced by any depletion or depreciation that would have been allowed or allowable if the partnership had previously chosen the optional adjustment.

The choice must be made with the partner's tax return for the year of the distribution if the distribution includes any property subject to depreciation, depletion, or amortization. If the choice does not have to be made for the distribution year, it must be made with the return for the first year in which the basis of the distributed property is pertinent in determining the partner's income tax.

A partner choosing this special basis adjustment must attach a statement to his or her tax return that the partner chooses under section 732(d) of the Internal Revenue Code to adjust the basis of property received in a distribution. The statement must show the computation of the special basis adjustment for the property distributed and list the properties to which the adjustment has been allocated.

Example. Bob purchased a 25% interest in X partnership for \$17,000 cash. At the time of the purchase, the partnership owned inventory having a basis to the partnership of \$14,000 and a fair market value of \$16,000. Thus, \$4,000 of the \$17,000 he paid was attributable to his share of inventory with a basis to the partnership of \$3,500.

Within 2 years after acquiring his interest, Bob withdrew from the partnership and for his entire interest received cash of \$1,500, inventory with a basis to the partnership of \$3,500, and other property with a basis of \$6,000. The value of the inventory received was 25% of the value of all partnership inventory. (It is immaterial whether the inventory he received was on hand when he acquired his interest.)

Since the partnership from which Bob withdrew did not make the optional adjustment to basis, he chose to adjust the basis of the inventory received. His share of the partnership's basis for the inventory is increased by \$500 (25% of the \$2,000 difference between the \$16,000 fair market value of the inventory and its \$14,000 basis to the partnership at the time he acquired his interest). The adjustment applies only for purposes of determining his new basis in the inventory, and **not** for purposes of partnership gain or loss on disposition.

The total to be allocated among the properties Bob received in the distribution is \$15,500 (\$17,000 basis of his interest - \$1,500 cash received). His basis in the inventory items is \$4,000 (\$3,500 partnership basis + \$500 special adjustment). The remaining \$11,500 is allocated to his new basis for the other property he received.

Mandatory adjustment. A partner does not always have a choice of making this special adjustment to basis. The special adjustment to basis **must** be made for a distribution of property, (whether or not within 2 years after the partnership interest was acquired) if all the following conditions existed when the partner received the partnership interest.

- The fair market value of all partnership property (other than money) was more than 110% of its adjusted basis to the partnership.
- If there had been a liquidation of the partner's interest immediately after it was acquired, an allocation of the basis of that interest under the general rules (discussed earlier under *Basis divided among properties*) would have decreased the basis of property that could not be depreciated, depleted, or amortized and increased the basis of property that could be.
- The optional basis adjustment, if it had been chosen by the partnership, would have changed the partner's basis for the property actually distributed.

Required statement. Generally, if a partner chooses a special basis adjustment and notifies the partnership, or if the partnership makes a distribution for which the special basis adjustment is mandatory, the partnership must provide a statement to the partner. The statement must provide information necessary for the partner to compute the special basis adjustment.

Marketable securities. A partner's basis in marketable securities received in a partnership distribution, as determined in the preceding discussions, is increased by any gain recognized by treating the securities as money. See *Marketable securities treated as money* under *Partner's Gain or Loss*, earlier. The basis increase is allocated among the securities in proportion to their respective amounts of unrealized appreciation before the basis increase.

VIII. Transactions Between Partnership and Partners

For certain transactions between a partner and his or her partnership, the partner is treated as not being a member of the partnership. These transactions include the following.

1. Performing services for or transferring property to a partnership if:
 - a. There is a related allocation and distribution to a partner, and
 - b. The entire transaction, when viewed together, is properly characterized as occurring between the partnership and a partner not acting in the capacity of a partner.
2. Transferring money or other property to a partnership if:
 - a. There is a related transfer of money or other property by the partnership to the contributing partner or another partner, and
 - b. The transfers together are properly characterized as a sale or exchange of property.

Payments by accrual basis partnership to cash basis partner. A partnership that uses an accrual method of accounting cannot deduct any business expense owed to a cash basis partner until the amount is paid. However, this rule does not apply to guaranteed payments made to a partner, which are generally deductible when accrued.

GUARANTEED PAYMENTS

Guaranteed payments are those made by a partnership to a partner that are determined without regard to the partnership's income. A partnership treats guaranteed payments for services, or for the use of capital, as if they were made to a person who is not a partner. This treatment is for purposes of determining gross income and deductible business expenses only. For other tax purposes, guaranteed payments are treated as a partner's distributive share of ordinary income. Guaranteed payments are not subject to income tax withholding.

The partnership generally deducts guaranteed payments on line 10 of Form 1065 as a business expense. They are also listed on Schedules K and K-1 of the partnership return. The individual partner reports guaranteed payments on Schedule E (Form 1040) as ordinary income, along with his or her distributive share of the partnership's other ordinary income.

Guaranteed payments made to partners for organizing the partnership or syndicating interests in the partnership are capital expenses. Generally, organizational and syndication expenses are not deductible by the partnership. However, a partnership can elect to deduct a portion of its organizational expenses and amortize the remaining expenses (see *Business start-up and organizational costs* in the instructions for Form 1065). Organizational expenses (if the election is not made) and syndication expenses paid to partners must be reported on the partners' Schedule K-1 as guaranteed payments.

Minimum payment. If a partner is to receive a minimum payment from the partnership, the guaranteed payment is the amount by which the minimum payment is more than the partner's distributive share of the partnership income **before** taking into account the guaranteed payment.

Example. Under a partnership agreement, Sandy is to receive 30% of the partnership income, but not less than \$8,000. The partnership has net income of \$20,000. Sandy's share, without regard to the minimum guarantee, is \$6,000 (30% X \$20,000). The guaranteed payment that can be deducted by the partnership is \$2,000 (\$8,000 - \$6,000). Sandy's income from the partnership is \$8,000, and the remaining \$12,000 of partnership income will be reported by the other partners in proportion to their shares under the partnership agreement.

If the partnership net income had been \$30,000, there would have been no guaranteed payment since her share, without regard to the guarantee, would have been greater than the guarantee.

Self-employed health insurance premiums. Premiums for health insurance paid by a partnership on behalf of a partner for services as a partner are treated as guaranteed payments. The partnership can deduct the payments as a business expense and the partner must include them in gross income. However, if the partnership accounts for insurance paid for a partner as a reduction in distributions to the partner, the partnership cannot deduct the premiums.

A partner who qualifies can deduct 100% of the health insurance premiums paid by the partnership on his or her behalf as an adjustment to income. The partner cannot deduct the premiums for any calendar month or part of a month in which the partner is eligible to participate in any subsidized health plan maintained by any employer of the partner or the partner's spouse.

Including payments in partner's income. Guaranteed payments are included in income in the partner's tax year in which the partnership's tax year ends.

Example 1. Under the terms of a partnership agreement, Erica is entitled to a fixed annual payment of \$10,000 without regard to the income of the partnership. Her distributive share of the partnership income is 10%. The partnership has \$50,000 of ordinary income after deducting the guaranteed payment. She must include ordinary income of \$15,000 (\$10,000 guaranteed payment + \$5,000 (\$50,000 X 10%) distributive share) on her individual income tax return for her tax year in which the partnership's tax year ends.

Example 2. Mike is a calendar year taxpayer who is a partner in a partnership. The partnership uses a fiscal year that ended January 31, 2009. Mike received guaranteed payments from the partnership from February 1, 2008, until December 31, 2008. He must include these guaranteed payments in income for 2009 and report them on his 2009 income tax return.

Payments resulting in loss. If guaranteed payments to a partner result in a partnership loss in which the partner shares, the partner must report the full amount of the guaranteed payments as ordinary income. The partner separately takes into account his or her distributive share of the partnership loss, to the extent of the adjusted basis of the partner's partnership interest.

SALE OR EXCHANGE OF PROPERTY

Special rules apply to a sale or exchange of property between a partnership and certain persons.

Losses. Losses will not be allowed from a sale or exchange of property (other than an interest in the partnership) directly or indirectly between a partnership and a person whose direct or indirect interest in the capital or profits of the partnership is more than 50%.

If the sale or exchange is between two partnerships in which the same persons directly or indirectly own more than 50% of the capital or profits interests in each partnership, no deduction of a loss is allowed.

The basis of each partner's interest in the partnership is decreased (but not below zero) by the partner's share of the disallowed loss.

If the purchaser later sells the property, only the gain realized that is greater than the loss not allowed will be taxable. If any gain from the sale of the property is not recognized because of this rule, the basis of each partner's interest in the partnership is increased by the partner's share of that gain.

Gains. Gains are treated as ordinary income in a sale or exchange of property directly or indirectly between a person and a partnership, or between two partnerships, if both of the following tests are met.

- More than 50% of the capital or profits interest in the partnership(s) is directly or indirectly owned by the same person(s).
- The property in the hands of the transferee immediately after the transfer is not a capital asset. Property that is not a capital asset includes accounts receivable, inventory, stock-in-trade, and depreciable or real property used in a trade or business.

More than 50% ownership. To determine if there is more than 50% ownership in partnership capital or profits, the following rules apply.

1. An interest directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered to be owned proportionately by or for its shareholders, partners, or beneficiaries.
2. An individual is considered to own the interest directly or indirectly owned by or for the individual's family. For this rule, "family" includes only brothers, sisters, half-brothers, half-sisters, spouses, ancestors, and lineal descendants.
3. If a person is considered to own an interest using rule (1), that person (the "constructive owner") is treated as if actually owning that interest when rules (1) and (2) are applied. However, if a person is considered to own an interest using rule (2), that person is not treated as actually owning that interest in reapplying rule (2) to make another person the constructive owner.

Example. Individuals A and B and Trust T are equal partners in Partnership ABT. A's husband, AH, is the sole beneficiary of Trust T. Trust T's partnership interest will be attributed to AH only for the purpose of further attributing the interest to A. As a result, A is a more-than-50% partner. This means that any deduction for losses on transactions between her and ABT will not be allowed, and gain from property that in the hands of the transferee is not a capital asset is treated as ordinary, rather than capital, gain.

CONTRIBUTION OF PROPERTY

Usually, neither the partner nor the partnership recognizes a gain or loss when property is contributed to the partnership in exchange for a partnership interest. This applies whether a partnership is being formed or is already operating. The partnership's holding period for the property includes the partner's holding period.

The contribution of limited partnership interests in one partnership for limited partnership interests in another partnership qualifies as a tax-free contribution of property to the second partnership if the transaction is made for business purposes. The exchange is not subject to the rules explained later under *Disposition of Partner's Interest*.

Disguised sales. A contribution of money or other property to the partnership followed by a distribution of different property from the partnership to the partner is treated not as a contribution and distribution, but as a sale of property, if both of the following tests are met.

- The distribution would not have been made but for the contribution.
- The partner's right to the distribution does not depend on the success of partnership operations.

All facts and circumstances are considered in determining if the contribution and distribution are more properly characterized as a sale. However, if the contribution and distribution occur within 2 years of each other, the transfers are presumed to be a sale unless the facts clearly indicate that the transfers are not a sale. If the contribution and distribution occur more than 2 years apart, the transfers are presumed not to be a sale unless the facts clearly indicate that the transfers are a sale.

Form 8275 required. A partner must attach Form 8275, *Disclosure Statement*, (or other statement) to his or her return if the partner contributes property to a partnership and, within 2 years (before or after the contribution), the partnership transfers money or other consideration to the partner. For exceptions to this requirement, see section 1.707-3(c)(2) of the regulations.

A partnership must attach Form 8275 (or other statement) to its return if it distributes property to a partner, and, within 2 years (before or after the distribution), the partner transfers money or other consideration to the partnership.

Form 8275 must include the following information.

- A caption identifying the statement as a disclosure under section 707 of the Internal Revenue Code.

- A description of the transferred property or money, including its value.
- A description of any relevant facts in determining if the transfers are properly viewed as a disguised sale. (See section 1.707-3(b)(2) of the regulations for a description of the facts and circumstances considered in determining if the transfers are a disguised sale.)

Contribution to investment company. Gain is recognized when property is contributed (in exchange for an interest in the partnership) to a partnership that would be treated as an investment company if it were incorporated.

A partnership is generally treated as an investment company if over 80% of the value of its assets is held for investment and consists of certain readily marketable items. These items include money, stocks and other equity interests in a corporation, and interests in regulated investment companies and real estate investment trusts. For more information, see section 351(e)(1) of the Internal Revenue Code and the related regulations. Whether a partnership is an investment company under this test is ordinarily determined immediately after the transfer of property.

This rule applies to limited partnerships and general partnerships, regardless of whether they are privately formed or publicly syndicated.

Contribution to foreign partnership. A domestic partnership that contributed property after August 5, 1997, to a foreign partnership in exchange for a partnership interest may have to file **Form 8865** if either of the following apply.

1. Immediately after the contribution, the partnership owned, directly or indirectly, at least a 10% interest in the foreign partnership.
2. The fair market value of the property contributed to the foreign partnership, when added to other contributions of property made to the partnership during the preceding 12-month period, is greater than \$100,000.

The partnership may also have to file Form 8865, even if no contributions are made during the tax year, if it owns a 10% or more interest in a foreign partnership at any time during the year. See the form instructions for more information.

Basis of contributed property. If a partner contributes property to a partnership, the partnership's basis for determining depreciation, depletion, and gain or loss for the property is the same as the partner's adjusted basis for the property when it was contributed, increased by any gain recognized by the partner at the time of contribution.

Allocations to account for built-in gain or loss. The fair market value of property at the time it is contributed may be different from the partner's adjusted basis. The partnership must allocate among the partners any income, deduction, gain, or loss on the property in a manner that will account for the difference. This rule also applies to contributions of accounts payable and other accrued but unpaid items of a cash basis partner.

The partnership can use different allocation methods for different items of contributed property. A single reasonable method must be consistently applied to each item, and the overall method or combination of methods must be reasonable. See section 1.704-3 of the regulations for allocation methods generally considered reasonable.

If the partnership sells contributed property and recognizes gain or loss, built-in gain or loss is allocated to the contributing partner. If contributed property is subject to depreciation or other cost recovery, the allocation of deductions for these items takes into account built-in gain or loss on the property. However, the total depreciation, depletion, gain, or loss allocated to partners cannot be more than the depreciation or depletion allowable to the partnership or the gain or loss realized by the partnership.

Example. Sara and Gail formed an equal partnership. Sara contributed \$10,000 in cash to the partnership and Gail contributed depreciable property with a fair market value of \$10,000 and an adjusted basis of \$4,000. The partnership's basis for depreciation is limited to the adjusted basis of the property in Gail's hands, \$4,000.

In effect, Sara purchased an undivided one-half interest in the depreciable property with her contribution of \$10,000. Assuming that the depreciation rate is 10% a year under the General Depreciation System (GDS), she would have been entitled to a depreciation deduction of \$500 per year, based on her interest in the partnership, if the adjusted basis of the property equaled its fair market value when contributed. (To simplify this example, the depreciation deductions are determined without regard to any first-year depreciation conventions.)

However, since the partnership is allowed only \$400 per year of depreciation (10% of \$4,000), no more than \$400 can be allocated between the partners. The entire \$400 must be allocated to Sara.

Distribution of contributed property to another partner. If a partner contributes property to a partnership and the partnership distributes the property to another partner within 7 years of the contribution, the contributing partner must recognize gain or loss on the distribution.

Caution. *A 5-year period applies to property contributed before June 9, 1997, or under a written binding contract:*

- *That was in effect on June 8, 1997, and at all times thereafter before the contribution, and*
- *That provides for the contribution of a fixed amount of property.*

The recognized gain or loss is the amount the contributing partner would have recognized if the property had been sold for its fair market value when it was distributed. This amount is the difference between the property's basis and its fair market value at the time of contribution. The character of the gain or loss will be the same as the character of the gain or loss that would have resulted if the partnership had sold the property to the distributee partner. Appropriate adjustments must be made to the adjusted basis of the contributing partner's partnership interest and to the adjusted basis of the property distributed to reflect the recognized gain or loss.

Disposition of certain contributed property. The following rules determine the character of the partnership's gain or loss on a disposition of certain types of contributed property.

1. **Unrealized receivables.** If the property was an unrealized receivable in the hands of the contributing partner, any gain or loss on its disposition by the partnership is ordinary income or loss. Unrealized receivables are defined later under *Payments for Unrealized Receivables and Inventory Items*. When reading the definition, substitute "partner" for "partnership."
2. **Inventory items.** If the property was an inventory item in the hands of the contributing partner, any gain or loss on its disposition by the partnership within 5 years after the contribution is ordinary income or loss. Inventory items are defined later in *Payments for Unrealized Receivables and Inventory Items*.
3. **Capital loss property.** If the property was a capital asset in the contributing partner's hands, any loss on its disposition by the partnership within 5 years after the contribution is a capital loss. The capital loss is limited to the amount by which the partner's adjusted basis for the property exceeded the property's fair market value immediately before the contribution.
4. **Substituted basis property.** If the disposition of any of the property listed in (1), (2), or (3) is a nonrecognition transaction, these rules apply when the recipient of the property disposes of any substituted basis property (other than certain corporate stock) resulting from the transaction.

CONTRIBUTION OF SERVICES

A partner can acquire an interest in partnership capital or profits as compensation for services performed or to be performed.

Capital interest. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest. The fair market value of such an interest received by a partner as compensation for services must generally be included in the partner's gross income in the first tax year in which the partner can transfer the interest or the interest is not subject to a substantial risk of forfeiture.

The fair market value of an interest in partnership capital transferred to a partner as payment for services to the partnership is a guaranteed payment, discussed earlier.

Profits interest. A profits interest is a partnership interest other than a capital interest. If a person receives a profits interest for providing services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the receipt of such an interest is not a taxable event for the partner or the partnership. However, this does not apply in the following situations.

- The profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease.
- Within 2 years of receipt, the partner disposes of the profits interest.
- The profits interest is a limited partnership interest in a publicly traded partnership.

A profits interest transferred as compensation for services is not subject to the rules for restricted property that apply to capital interests.

IX. Basis of Partner's Interest

The basis of a partnership interest is the money plus the adjusted basis of any property the partner contributed. If the partner must recognize gain as a result of the contribution, this gain is included in the basis of his or her interest. Any increase in a partner's individual liabilities because of an assumption of partnership liabilities is considered a contribution of money to the partnership by the partner.

Interest acquired by gift, etc. If a partner acquires an interest in a partnership by gift, inheritance, or under any circumstance other than by a contribution of money or property to the partnership, the partner's basis must be determined using the basis rules described in Publication 551.

ADJUSTED BASIS

Tip. There is a worksheet for adjusting the basis of a partner's interest in the partnership in the Partner's Instructions for Schedule K-1 (Form 1065).

The basis of an interest in a partnership is increased or decreased by certain items.

Increases. A partner's basis is increased by the following items.

- The partner's additional contributions to the partnership, including an increased share of or assumption of partnership liabilities.
- The partner's distributive share of taxable and nontaxable partnership income.
- The partner's distributive share of the excess of the deductions for depletion over the basis of the depletable property, unless the property is oil or gas wells whose basis has been allocated to partners.

Decreases. The partner's basis is decreased (but never below zero) by the following items.

- The money (including a decreased share of partnership liabilities or an assumption of the partner's individual liabilities by the partnership) and adjusted basis of property distributed to the partner by the partnership.
- The partner's distributive share of the partnership losses (including capital losses).
- The partner's distributive share of nondeductible partnership expenses that are not capital expenditures. This includes the partner's share of any section 179 expenses, even if the partner cannot deduct the entire amount on his or her individual income tax return.
- The partner's deduction for depletion for any partnership oil and gas wells, up to the proportionate share of the adjusted basis of the wells allocated to the partner.

Partner's liabilities assumed by partnership. If contributed property is subject to a debt or if a partner's liabilities are assumed by the partnership, the basis of that partner's interest is reduced (but not below zero) by the liability assumed by the other partners. This partner must reduce his or her basis because the assumption of the liability is treated as a distribution of money to that partner. The other partners' assumption of the

liability is treated as a contribution by them of money to the partnership. See *Effect of Partnership Liabilities*, later.

Example 1. John acquired a 20% interest in a partnership by contributing property that had an adjusted basis to him of \$8,000 and a \$4,000 mortgage. The partnership assumed payment of the mortgage. The basis of John's interest is:

Adjusted basis of contributed property	\$8,000
Minus: Part of mortgage assumed by other partners (80% x \$4,000)	<u>3,200</u>
Basis of John's partnership interest	<u>\$4,800</u>

Example 2. If, in Example 1, the contributed property had a \$12,000 mortgage, the basis of John's partnership interest would be zero. The \$1,600 difference between the mortgage assumed by the other partners, \$9,600 (80% X \$12,000), and his basis of \$8,000 would be treated as capital gain from the sale or exchange of a partnership interest. However, this gain **would not** increase the basis of his partnership interest.

Book value of partner's interest. The adjusted basis of a partner's interest is determined without considering any amount shown in the partnership books as a capital, equity, or similar account.

Example. Sam contributes to his partnership property that has an adjusted basis of \$400 and a fair market value of \$1,000. His partner contributes \$1,000 cash. While each partner has increased his capital account by \$1,000, which will be reflected in the partnership books, the adjusted basis of Sam's interest is only \$400 and the adjusted basis of his partner's interest is \$1,000.

When determined. The adjusted basis of a partner's partnership interest is ordinarily determined at the end of the partnership's tax year. However, if there has been a sale or exchange of all or part of the partner's interest or a liquidation of his or her entire interest in a partnership, the adjusted basis is determined on the date of sale, exchange, or liquidation.

Alternative rule for figuring adjusted basis. In certain cases, the adjusted basis of a partnership interest can be figured by using the partner's share of the adjusted basis of partnership property that would be distributed if the partnership terminated.

This alternative rule can be used in either of the following situations.

- The circumstances are such that the partner cannot practicably apply the general basis rules.
- It is, in the opinion of the IRS, reasonable to conclude that the result produced will not vary substantially from the result under the general basis rules.

Adjustments may be necessary in figuring the adjusted basis of a partnership interest under the alternative rule. For example, adjustments would be required to include in the partner's share of the adjusted basis of partnership property any significant discrepancies that resulted from contributed property, transfers of partnership interests, or distributions of property to the partners.

EFFECT OF PARTNERSHIP LIABILITIES

A partner's basis in a partnership interest includes the partner's share of a partnership liability only if, and to the extent that, the liability:

1. Creates or increases the partnership's basis in any of its assets,
2. Gives rise to a current deduction to the partnership, or
3. Is a nondeductible, noncapital expense of the partnership.

The term "assets" in (1) includes capitalized items allocable to future periods, such as organization expenses.

A partner's share of accrued but unpaid expenses or accounts payable of a cash basis partnership are not included in the adjusted basis of the partner's interest in the partnership.

Partner's basis increased. If a partner's share of partnership liabilities increases, or a partner's individual liabilities increase because he or she assumes partnership liabilities, this increase is treated as a contribution of money by the partner to the partnership.

Partner's basis decreased. If a partner's share of partnership liabilities decreases, or a partner's individual liabilities decrease because the partnership assumes his or her individual liabilities, this decrease is treated as a distribution of money to the partner by the partnership.

Assumption of liability. A partner or related person is considered to assume a partnership liability only to the extent that:

1. He or she is personally liable for it,
2. The creditor knows that the liability was assumed by the partner or related person,
3. The creditor can demand payment from the partner or related person, and
4. No other partner or person related to another partner will bear the economic risk of loss on that liability immediately after the assumption.

Related person. Related persons, for these purposes, includes all the following.

- An individual and his or her spouse, ancestors, and lineal descendants.
- An individual and a corporation if the individual directly or indirectly owns 80% or more in value of the outstanding stock of the corporation.
- Two corporations that are members of the same controlled group.
- A grantor and a fiduciary of any trust.
- Fiduciaries of two separate trusts if the same person is a grantor of both trusts.
- A fiduciary and a beneficiary of the same trust.
- A fiduciary and a beneficiary of two separate trusts if the same person is a grantor of both trusts.
- A fiduciary of a trust and a corporation if the trust or the grantor of the trust directly or indirectly owns 80% or more in value of the outstanding stock of the corporation.
- A person and a tax-exempt educational or charitable organization controlled directly or indirectly by the person or by members of the person's family.

- A corporation and a partnership if the same persons own 80% or more in value of the outstanding stock of the corporation and 80% or more of the capital or profits interest in the partnership.
- Two S corporations or an S corporation and a C corporation if the same persons own 80% or more in value of the outstanding stock of each corporation.
- An executor and a beneficiary of an estate.
- A partnership and a person owning, directly or indirectly, 80% or more of the capital or profits interest in the partnership.
- Two partnerships if the same persons directly or indirectly own 80% or more of the capital or profits interests.

Property subject to a liability. If property contributed to a partnership by a partner or distributed by the partnership to a partner is subject to a liability, the transferee is treated as having assumed the liability to the extent it does not exceed the fair market value of the property.

Partner's share of recourse liabilities. A partnership liability is a recourse liability to the extent that any partner or a related person, defined earlier, has an economic risk of loss for that liability. A partner's share of a recourse liability equals his or her economic risk of loss for that liability. A partner has an economic risk of loss if that partner or a related person would be obligated (whether by agreement or law) to make a net payment to the creditor or a contribution to the partnership with respect to the liability if the partnership were constructively liquidated. A partner who is the creditor for a liability that would otherwise be a nonrecourse liability of the partnership has an economic risk of loss in that liability.

Constructive liquidation. Generally, in a constructive liquidation, the following events are treated as occurring at the same time.

- All partnership liabilities become payable in full.
- All of the partnership's assets have a value of zero, except for property contributed to secure a liability.
- All property is disposed of by the partnership in a fully taxable transaction for no consideration except relief from liabilities for which the creditor's right to reimbursement is limited solely to one or more assets of the partnership.
- All items of income, gain, loss, or deduction are allocated to the partners.
- The partnership liquidates.

Example. Ted and Jane form a cash basis general partnership with cash contributions of \$20,000 each. Under the partnership agreement, they share all partnership profits and losses equally. They borrow \$60,000 and purchase depreciable business equipment. This debt is included in the partners' basis in the partnership because incurring it creates an additional \$60,000 of basis in the partnership's depreciable property.

If neither partner has an economic risk of loss in the liability, it is a nonrecourse liability. Each partner's basis would include his or her share of the liability, \$30,000.

If Jane is required to pay the creditor if the partnership defaults, she has an economic risk of loss in the liability. Her basis in the partnership would be \$80,000 (\$20,000 + \$60,000), while Ted's basis would be \$20,000.

Limited partner. A limited partner generally has no obligation to contribute additional capital to the partnership and therefore does not have an economic risk of loss in partnership recourse liabilities. Thus, absent some other factor, such as the guarantee of a partnership liability by the limited partner or the limited partner making the loan to the partnership, a limited partner generally does not have a share of partnership recourse liabilities.

Partner's share of nonrecourse liabilities. A partnership liability is a nonrecourse liability if no partner or related person has an economic risk of loss for that liability. A partner's share of nonrecourse liabilities is generally proportionate to his or her share of partnership profits. However, this rule may not apply if the partnership has taken deductions attributable to nonrecourse liabilities or the partnership holds property that was contributed by a partner.

More information. For more information on the effect of partnership liabilities, including rules for limited partners and examples, see sections 1.752-1 through 1.752-5 of the regulations.

X. Disposition of Partner's Interest

The following discussions explain the treatment of gain or loss from the disposition of an interest in a partnership.

Abandoned or worthless partnership interest. A loss incurred from the abandonment or worthlessness of a partnership interest is an ordinary loss only if both of the following tests are met.

- The transaction is not a sale or exchange.
- The partner has not received an actual or deemed distribution from the partnership.

If the partner receives even a de minimis actual or deemed distribution, the entire loss generally is a capital loss. However, see *Payments for Unrealized Receivables and Inventory Items*, later.

Partnership election to adjust basis of partnership property. Generally, a partnership's basis in its assets is not affected by a transfer of an interest in the partnership, whether by sale or exchange or because of the death of a partner. However, the partnership can elect to make an optional adjustment to basis in the year of transfer.

SALE, EXCHANGE, OR OTHER TRANSFER

The sale or exchange of a partner's interest in a partnership usually results in capital gain or loss. However, see *Payments for Unrealized Receivables and Inventory Items*, later, for certain exceptions. Gain or loss is the difference between the amount realized and the adjusted basis of the partner's interest in the partnership. If the selling partner is relieved of any partnership liabilities, that partner must include the liability relief as part of the amount realized for his or her interest.

Example 1. Fred became a limited partner in the ABC Partnership by contributing \$10,000 in cash on the formation of the partnership. The adjusted basis of his partnership interest at the end of the current year is \$20,000, which includes his \$15,000 share of partnership liabilities. The partnership has no unrealized receivables or inventory items. Fred sells his interest in the partnership for \$10,000 in cash. He had been paid his share of the partnership income for the tax year.

Fred realizes \$25,000 from the sale of his partnership interest (\$10,000 cash payment + \$15,000 liability relief). He reports \$5,000 (\$25,000 realized - \$20,000 basis) as a capital gain.

Example 2. The facts are the same as in Example 1, except that Fred withdraws from the partnership when the adjusted basis of his interest in the partnership is zero. He is considered to have received a distribution of \$15,000, his relief of liability. He reports a capital gain of \$15,000.

Exchange of partnership interests. An exchange of partnership interests generally does not qualify as a nontaxable exchange of like-kind property. This applies regardless of whether they are general or limited partnership interests or interests in the same or different partnerships. However, under certain circumstances, such an exchange may be treated as a tax-free contribution of property to a partnership. See *Contribution of Property under Transactions Between Partnership and Partners*, earlier.

An interest in a partnership that has a valid election in effect under section 761(a) of the Internal Revenue Code to be excluded from the partnership rules of the Code is treated as an interest in each of the partnership assets and not as a partnership interest. See *Exclusion From Partnership Rules*, earlier.

Installment reporting for sale of partnership interest. A partner who sells a partnership interest at a gain may be able to report the sale on the installment method.

Part of the gain from the installment sale may be allocable to unrealized receivables or inventory items. See *Payments for Unrealized Receivables and Inventory Items*, later. The gain allocable to unrealized receivables and inventory items must be reported in the year of sale. The gain allocable to the other assets can be reported under the installment method.

PAYMENTS FOR UNREALIZED RECEIVABLES AND INVENTORY ITEMS

If a partner receives money or property in exchange for any part of a partnership interest, the amount due to his or her share of the partnership's unrealized receivables or inventory items results in ordinary income or loss. This amount is treated as if it were received for the sale or exchange of property that is not a capital asset.

This treatment applies to the unrealized receivables part of payments to a retiring partner or successor in interest of a deceased partner only if that part is not treated as paid in exchange for partnership property. See *Liquidation at Partner's Retirement or Death*, later.

Unrealized receivables. Unrealized receivables include any rights to payment not already included in income for the following items.

- Goods delivered or to be delivered to the extent the payment would be treated as received for property other than a capital asset.
- Services rendered or to be rendered.

These rights must have arisen under a contract or agreement that existed at the time of sale or distribution, even though the partnership may not be able to enforce payment until a later date. For example, unrealized receivables include accounts receivable of a cash method partnership and rights to payment for work or goods begun but incomplete at the time of the sale or distribution of the partner's share.

The basis for any unrealized receivables includes all costs or expenses for the receivables that were paid or accrued but not previously taken into account under the partnership's method of accounting.

Other items treated as unrealized receivables. Unrealized receivables include potential gain that would be ordinary income if the following partnership property were sold at its fair market value on the date of the payment.

- Mining property for which exploration expenses were deducted.
- Stock in a Domestic International Sales Corporation (DISC).
- Certain farm land for which expenses for soil and water conservation or land clearing were deducted.
- Franchises, trademarks, or trade names.
- Oil, gas, or geothermal property for which intangible drilling and development costs were deducted.
- Stock of certain controlled foreign corporations.
- Market discount bonds and short-term obligations.
- Property subject to recapture of depreciation under sections 1245 and 1250 of the Internal Revenue Code.

Determining gain or loss. The income or loss realized by a partner upon the sale or exchange of its interest in unrealized receivables and inventory items, discussed below, is the amount that would have been allocated to the partner if the partnership had sold all of its property for cash at fair market value, in a fully taxable transaction, immediately prior to the partner's transfer of interest in the partnership. Any gain or loss recognized that is attributable to the unrealized receivables and inventory items will be ordinary gain or loss.

Example. You are a partner in ABC Partnership. The adjusted basis of your partnership interest at the end of the current year is zero. Your share of potential ordinary income from partnership depreciable property is \$5,000. The partnership has no other unrealized receivables or inventory items. You sell your interest in the partnership for \$10,000 in cash and you report the entire amount as a gain since your adjusted basis in the partnership is zero. You report as ordinary income your \$5,000 share of potential ordinary income from the partnership's depreciable property. The remaining \$5,000 gain is a capital gain.

Inventory items. Inventory items are not just stock-in-trade of the partnership. They also include the following property.

- Property that would properly be included in the partnership's inventory if on hand at the end of the tax year or that is held primarily for sale to customers in the normal course of business.
- Property that, if sold or exchanged by the partnership, would not be a capital asset or section 1231 property (real or depreciable business property held more than one year). For example, accounts receivable acquired for services or from the sale of inventory and unrealized receivables are inventory items.
- Property held by the partnership that would be considered inventory if held by the partner selling the partnership interest or receiving the distribution.

Notification required of partner. If a partner exchanges a partnership interest attributable to unrealized receivables or inventory for money or property, he or she must notify the partnership in writing. This must be done within 30 days of the transaction or, if earlier, by January 15 of the calendar year following the calendar year of the exchange. A partner may be subject to a \$50 penalty for each failure to notify the partnership about such a transaction, unless the failure was due to reasonable cause and not willful neglect.

Information return required of partnership. When a partnership is notified of an exchange of partnership interests involving unrealized receivables or inventory items, the partnership must file **Form 8308**. Form 8308 is filed with Form 1065 for the tax year that includes the last day of the calendar year in which the exchange took place. If notified of an exchange after filing Form 1065, the partnership must file Form 8308 separately, within 30 days of the notification.

On Form 8308, the partnership states the date of the exchange and the names, addresses, and taxpayer identification numbers of the partnership filing the return and the transferee and transferor in the exchange. The partnership must also provide a copy of Form 8308 (or a written statement with the same information) to each transferee and transferor by the later of January 31 following the end of the calendar year or 30 days after it receives notice of the exchange.

The partnership may be subject to a penalty of up to \$50 for each failure to timely file Form 8308 and a \$50 penalty for each failure to furnish a copy of Form 8308 to a transferor or transferee, unless the failure is due to reasonable cause and not willful neglect. If the failure is intentional, a higher penalty may be imposed. See the form instructions for details.

Statement required of partner. If a partner sells or exchanges any part of an interest in a partnership having unrealized receivables or inventory, he or she must file a statement with his or her tax return for the year in which the sale or exchange occurs. The statement must contain the following information.

- The date of the sale or exchange.
- The amount of any gain or loss attributable to the unrealized receivables or inventory.
- The amount of any gain or loss attributable to capital gain or loss on the sale of the partnership interest.

Partner's disposition of distributed unrealized receivables or inventory items. In general, any gain or loss on a sale or exchange of unrealized receivables or inventory items a partner received in a distribution is an ordinary gain or loss. For this purpose, inventory items do not include real or depreciable business property, even if they are not held more than 1 year.

Example. Mike, a distributee partner, received his share of accounts receivable when his law firm dissolved. The partnership used the cash method of accounting, so the receivables had a basis of zero. If Mike later collects the receivables or sells them, the amount he receives will be ordinary income.

Exception for inventory items held more than 5 years. If a distributee partner sells inventory items held for more than 5 years after the distribution, the type of gain or loss depends on how they are being used on the date sold. The gain or loss is capital gain or loss if the property is a capital asset in the partner's hands at the time sold.

Example. Ann receives, through dissolution of her partnership, inventory that has a basis of \$19,000. Within 5 years, she sells the inventory for \$24,000. The \$5,000 gain is taxed as ordinary income. If she had held the inventory for more than 5 years, her gain would have been capital gain, provided the inventory was a capital asset in her hands at the time of sale.

Substituted basis property. If a distributee partner disposes of unrealized receivables or inventory items in a nonrecognition transaction, ordinary gain or loss treatment applies to a later disposition of any substituted basis property resulting from the transaction.

LIQUIDATION AT PARTNER'S RETIREMENT OR DEATH

Payments made by the partnership to a retiring partner or successor in interest of a deceased partner in return for the partner's entire interest in the partnership may have to be allocated between payments in liquidation of the partner's interest in partnership property and other payments. The partnership's payments include an assumption of the partner's share of partnership liabilities treated as a distribution of money.

For income tax purposes, a retiring partner or successor in interest of a deceased partner is treated as a partner until his or her interest in the partnership has been completely liquidated.

Liquidating payments. Payments made in liquidation of the interest of a retiring or deceased partner in exchange for his or her interest in partnership property are considered a distribution, not a distributive share or guaranteed payment that could give rise to a deduction (or its equivalent) for the partnership.

Unrealized receivables and goodwill. Payments made for the retiring or deceased partner's share of the partnership's unrealized receivables or goodwill are not treated as made in exchange for partnership property if both of the following tests are met.

- Capital is not a material income-producing factor for the partnership. (Whether capital is a material income-producing factor is explained in the discussion under *Family Partnership* near the beginning of this chapter.)
- The retiring or deceased partner was a general partner in the partnership.

However, this rule does not apply to payments for goodwill to the extent that the partnership agreement provides for a reasonable payment to a retiring partner for goodwill.

Unrealized receivables includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered, or to be rendered.

Partners' valuation. Generally, the partners' valuation of a partner's interest in partnership property in an arm's-length agreement will be treated as correct. If the valuation reflects only the partner's net interest in the property (total assets less liabilities), it must be adjusted so that both the value of and the basis for the partner's interest include the partner's share of partnership liabilities.

Gain or loss on distribution. Upon the receipt of the distribution, the retiring partner or successor in interest of a deceased partner will recognize gain only to the extent that any money (and marketable securities treated as money) distributed is more than the partner's adjusted basis in the partnership. The partner will recognize a loss only if the distribution is in money, unrealized receivables, and inventory items. No loss is recognized if any other property is received. See *Partner's Gain or Loss* under *Partnership Distributions*, earlier.

Other payments. Payments made by the partnership to a retiring partner or successor in interest of a deceased partner that are **not** made in exchange for an interest in partnership property are treated as distributive shares of partnership income or guaranteed payments. This rule applies regardless of the time over which the payments are to be made. It applies to payments made for the partner's share of unrealized receivables and goodwill not treated as a distribution.

If the amount is based on partnership income, the payment is taxable as a distributive share of partnership income. The payment retains the same character when reported by the recipient that it would have had if reported by the partnership.

If the amount is not based on partnership income, it is treated as a guaranteed payment. The recipient reports guaranteed payments as ordinary income. For additional information on guaranteed payments, see *Transactions Between Partnership and Partners*, earlier.

These payments are included in income by the recipient for his or her tax year that includes the end of the partnership tax year for which the payments are a distributive share or in which the partnership is entitled to deduct them as guaranteed payments.

Former partners who continue to make guaranteed periodic payments to satisfy the partnership's liability to a retired partner after the partnership is terminated can deduct the payments as a business expense in the year paid.

CHAPTER 3 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. The co-ownership of property maintained and rented is automatically treated as a partnership for federal tax purposes.
 - a) true
 - b) false
2. A husband and wife who own a qualified entity can choose to classify the entity as either a:
 - a) partnership or sole proprietorship
 - b) partnership or corporation
 - c) sole proprietorship or corporation
 - d) none of the above
3. Capital would generally be considered a material income-producing factor in which of the following types of business:
 - a) an accounting firm
 - b) a stock brokerage
 - c) a manufacturing company
 - d) a personal trainer
4. The partnership agreement cannot be modified after the close of the tax year.
 - a) true
 - b) false
5. The conversion of a partnership into an LLC classified as a partnership for federal tax purposes terminates the partnership.
 - a) true
 - b) false
6. Which of the following is required to file an information return on Form 1065:
 - a) all partnerships
 - b) all partnerships that engage in a trade or business
 - c) all partnerships that have gross income
 - d) both b and c above

7. Money or property withdrawn by a partner in anticipation of the current year's earnings is treated as a distribution received on the last day of the partnership's tax year.
- a) true
 - b) false
8. A partner does not recognize loss on a partnership distribution unless:
- a) the adjusted basis of the partner's interest in the partnership exceeds the distribution
 - b) the partner's entire interest in the partnership is liquidated
 - c) the distribution is in money, unrealized receivables, or inventory items
 - d) all of the above must be met
9. Unless there is a complete liquidation of a partner's interest, the basis of property (other than money) distributed to a partner by a partnership is:
- a) the fair market value of the property
 - b) the value of the property when acquired by the partnership
 - c) the adjusted basis to the partnership immediately before the distribution
 - d) the historical cost of the property
10. Guaranteed payments are those made by a partnership to a partner that are determined without regard to the partnership's income, and therefore are subject to income tax withholding.
- a) true
 - b) false
11. If a sale occurs between a partnership and a person whose direct or indirect interest in the capital or profits of the partnership is more than 50%, deduction of losses:
- a) are limited to \$3,000
 - b) are not allowed
 - c) are unlimited
 - d) are limited to 50% of the loss
12. If a partner contributes property to a partnership and the partnership distributes the property to another partner within seven years of the contribution, the contributing partner must recognize gain or loss on the distribution.
- a) true
 - b) false

13. A partner's basis of an interest in a partnership is decreased by which of the following:
- a) the partner's additional contributions to the partnership
 - b) the partner's distributive share of the partnership losses
 - c) the partner's distributive share of taxable partnership income
 - d) all of the above
14. If a partner's share of partnership liabilities increases, this increase is treated as a contribution of money by the partner to the partnership.
- a) true
 - b) false
15. A loss incurred from the abandonment or worthlessness of a partnership interest is generally an ordinary loss.
- a) true
 - b) false
16. If a partner receives money or property in exchange for any part of a partnership interest, the amount due to his or her share of the partnership's unrealized receivables or inventory items results in ordinary income or loss.
- a) true
 - b) false
17. When a partnership is notified of an exchange of partnership interests involving unrealized receivables or inventory items, the partnership must file:
- a) Form 1065
 - b) Form 1099
 - c) Form 8282
 - d) Form 8308
18. Payments made to a retiring partner that are not based on partnership income are treated as:
- a) guaranteed payments
 - b) liquidating payments
 - c) either a or b above
 - d) none of the above

CHAPTER 3 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: True is incorrect. A joint undertaking merely to share expenses is not a partnership. The co-ownership of property maintained and rented is not a partnership unless the co-owners provide services to the tenants.

B: False is correct. An unincorporated organization with two or more members is generally classified as a partnership for federal tax purposes if its members carry on a trade, business, financial operation, or venture to divide profits. However, a joint undertaking merely to share expenses is not a partnership.

(See page 3-1 of the course material.)

2. **A: Correct.** For an entity to be qualified, the business must be wholly owned by a husband and wife as community property, no person other than one or both spouses would be considered an owner of the entity for federal tax purposes, and the business cannot be treated as a corporation.

B: Incorrect. One of the requirements is that the business entity is not treated as a corporation.

C: Incorrect. One of the requirements is that the business entity is not treated as a corporation.

D: Incorrect. Because one of the responses is correct, none of the above cannot be correct.

(See page 3-2 of the course material.)

3. A: Incorrect. In general, capital is not a material income-producing factor if the income of the business consists primarily of fees, commissions, or other compensation for personal services performed by members or employees of the partnership. Therefore, accounting firms would generally not have capital as a material income-producing factor.

B: Incorrect. In general, capital is not a material income-producing factor if the income of the business consists primarily of fees, commissions, or other compensation for personal services performed by members or employees of the partnership. Therefore, a stock brokerage would generally not have capital as a material income-producing factor.

C: Correct. Capital is ordinarily an income-producing factor if the operation of the business requires substantial inventories or investments in plants, machinery, or equipment.

D: Incorrect. In general, capital is not a material income-producing factor if the income of the business consists primarily of fees, commissions, or other compensation for personal services performed by members or employees of the partnership. Therefore, a personal trainer would generally not have capital as a material income-producing factor.

(See page 3-3 of the course material.)

4. A: True is incorrect. Partners can modify the partnership agreement for a particular tax year after the close of the year, but not later than the date for filing the partnership return for that year. This filing date does not include any extension of time.

B: False is correct. The partnership agreement can be oral or written. If the original agreement or its modifications are silent on any matter, the provisions of local law are treated as part of the agreement.

(See page 3-4 of the course material.)

5. A: True is incorrect. The conversion of a partnership into an LLC for federal tax purposes does not terminate the partnership.

B: False is correct. The conversion is not a sale, exchange, or liquidation of any partnership interest, the partnership's tax year does not close, and the LLC can continue to use the partnership's taxpayer identification number.

(See page 3-5 of the course material.)

6. A: Incorrect. If a partnership does not receive income or pay or incur any expenses treated as deductions or credits for federal income tax purposes, it is not required to file Form 1065.

B: Incorrect. This is a situation in which a partnership is required to file Form 1065, but this is not the best answer.

C: Incorrect. This is a situation in which a partnership is required to file Form 1065, but this is not the best answer.

D: Correct. These are both situations in which Form 1065 is required to be filed. The return must be signed by a general partner.

(See page 3-6 of the course material.)

7. **A: True is correct.** Partnership distributions include a withdrawal by a partner in anticipation of current earnings, a distribution of current year's or prior year's earnings, a complete or partial liquidation of a partner's interest, and a distribution to all partners in a complete liquidation of the partnership.

B: False is incorrect. A partnership distribution is not taken into account in determining the partner's distributive share of partnership income or loss. If any gain or loss from the distribution is recognized by the partner, it must be reported on his or her return for the tax year in which the distribution is received.

(See page 3-7 of the course material.)

8. A: Incorrect. This is one of the requirements, but it is not enough in itself.
B: Incorrect. This is one of the requirements, but it is not enough in itself.
C: Incorrect. This is one of the requirements, but it is not enough in itself.
D: Correct. All of these situations must be met in order for a loss to be recognized.
(See page 3-8 of the course material.)
9. A: Incorrect. The fair market value of the property may be greater than the value assigned.
B: Incorrect. A more relevant amount is used to value the distribution.
C: Correct. However, the basis of the property to the partner cannot be more than the adjusted basis of his or her interest in the partnership reduced by any money received in the same transaction.
D: Incorrect. A more relevant (current) value is used to value the distribution.
(See page 3-10 of the course material.)
10. A: True is incorrect. Guaranteed payments are not subject to income tax withholding.
B: False is correct. A partnership treats guaranteed payments for services, or for the use of capital, as if they were made to a person who is not a partner when determining both gross income and deductible business expenses. For other tax purposes, guaranteed payments are treated as a partner's distributive share of ordinary income.
(See page 3-14 of the course material.)
11. A: Incorrect. This is the limit of losses for investments for individuals.
B: Correct. The basis of each partner's interest in the partnership is decreased (but not below zero) by the partner's share of the disallowed loss.
C: Incorrect. The loss deduction is not unlimited.
D: Incorrect. There is no such 50% loss limitation.
(See page 3-16 of the course material.)

12. **A: True is correct.** The recognized gain or loss is the amount the contributing partner would have recognized if the property had been sold for its fair market value when it was distributed. The character of the gain or loss would be the same as the character of the gain or loss that would have resulted if the partnership had sold the property to the distributee partner.

B: False is incorrect. A five-year period applies to property contributed before June 9, 1997, or under a written binding contract that was in effect on June 8, 1997, and at all times thereafter before the contribution, and that provides for the contribution of a fixed amount of property.

(See page 3-19 of the course material.)

13. A: Incorrect. This would increase the partner's basis.

B: Correct. The partner's basis cannot be decreased below zero.

C: Incorrect. This would increase the partner's basis.

D: Incorrect. Since only one of the responses is correct, "all of the above" cannot be correct.

(See page 3-21 of the course material.)

14. **A: True is correct.** If a partner's share of partnership liabilities decreases, this decrease is treated as a distribution of money to the partner by the partnership.

B: False is incorrect. This is also true if the partner's individual liabilities increase because he or she assumes partnership liabilities.

(See page 3-23 of the course material.)

15. A: True is incorrect. The loss is characterized as an ordinary loss only if the transaction is not a sale or exchange, and the partner has not received an actual or deemed distribution from the partnership.

B: False is correct. Certain tests must be met for the loss to be considered ordinary, rather than capital. If a partner receives even a de minimis actual or deemed distribution, the entire loss generally is a capital loss.

(See page 3-25 of the course material.)

16. **A: True is correct.** This amount is treated as if it were received for the sale or exchange of property that is not a capital asset.

B: False is incorrect. This treatment applies to the unrealized receivables part of payments to a retiring partner or successor in interest of a deceased partner only if that part is not treated as paid in exchange for partnership property.

(See page 3-26 of the course material.)

17. A: Incorrect. This form is used as an informational return for partnerships, and needs to be filed with the necessary form.

B: Incorrect. Form 1099 is used to report other various forms of other income.

C: Incorrect. Form 8282 is used to report donee information.

D: Correct. On Form 8308, the partnership states the date of the exchange and the names, addresses, and taxpayer identification numbers of the partnership filing the return and the transferee and transferor in the exchange.

(See page 3-28 of the course material.)

18. **A: Correct.** The recipient reports guaranteed payments as ordinary income.

B: Incorrect. Liquidating payments are those made in liquidation in interest of a retiring or deceased partner in exchange for his or her interest in partnership property.

C: Incorrect. Only one of the responses is correct.

D: Incorrect. One of the responses is correct.

(See page 3-30 of the course material.)

Chapter 4: Tax Filing Forms and Instructions for Partnership Returns

The following information and line item instructions are provided to assist in the completion of partnership tax returns.

Detailed Instructions for Form 1065 – U.S. Return of Partnership Income

I. What's New

- Special rule for 2010 start-up costs. For tax years beginning in 2010, a partnership can elect to deduct up to \$10,000 of start-up costs. See section 195(b)(3). Also see *Business start-up and organizational costs*, later.
- The following credits are new for 2010. For details, see the various credit forms and instructions.
 - New Hire Retention Credit (Form 5884-B).
 - Credit for Small Employer Health Insurance Premiums (Form 8941).
 - Qualifying therapeutic discovery project credit (Form 8942).

II. General Instructions

DEFINITIONS

Partnership

A partnership is the relationship between two or more persons who join to carry on a trade or business, with each person contributing money, property, labor, or skill and each expecting to share in the profits and losses of the business whether or not a formal partnership agreement is made.

The term “partnership” includes a limited partnership, syndicate, group, pool, joint venture, or other unincorporated organization, through or by which any business, financial operation, or venture is carried on, that is not, within the meaning of the regulations under section 7701, a corporation, trust, estate, or sole proprietorship.

A joint undertaking merely to share expenses is not a partnership. Mere co-ownership of property that is maintained and leased or rented is not a partnership. However, if the co-owners provide services to the tenants, a partnership exists.

Husband-wife business. Generally, if you and your spouse jointly own and operate an unincorporated business and share in the profits and losses, you are partners in a partnership and you must file Form 1065.

Exception – Qualified joint venture. If you and your spouse materially participate as the only members of a jointly owned and operated business, and you file a joint return for the tax year, you can make an election to be treated as a qualified joint venture instead of a partnership. By making the election, you will not be required to file Form

1065 for any year the election is in effect and will instead report the income and deductions directly on your joint return.

To make this election, you must divide all items of income, gain, loss, deduction, and credit between you and your spouse in accordance with your respective interests in the venture. Each of you must file a separate Schedule C, C-EZ, or F. On each line of your separate Schedule C, C-EZ, or F, you must enter your share of the applicable income, deduction, or loss. Each of you also must file a separate Schedule SE to pay self-employment tax.

If you and your spouse make the election for your rental real estate business, you each must report your share of income and deductions on Schedule C or C-EZ instead of Schedule E. Although rental real estate income generally is not included in net earnings from self-employment, you and your spouse each must take into account your share of the income and deductions from the rental real estate business in figuring your net earnings from self-employment on Schedule SE.

To make the qualified joint venture election for 2010, jointly file the 2010 Form 1040 with the required schedules. This generally does not increase the total tax on the return, but it does give each spouse credit for social security earnings on which retirement benefits are based, provided neither spouse exceeds the social security tax limitation.

Once made, the election cannot be revoked without IRS consent. If you and your spouse filed a Form 1065 for the year prior to the election, you do not need to amend that return or file a final Form 1065 for the year the election takes effect. However, the partnership terminates at the end of the tax year immediately preceding the year the election takes effect.

Foreign Partnership

A foreign partnership is a partnership that is not created or organized in the United States or under the law of the United States or of any state.

General Partner

A general partner is a partner who is personally liable for partnership debts.

General Partnership

A general partnership is composed only of general partners.

Limited Partner

A limited partner is a partner in a partnership formed under a state limited partnership law, whose personal liability for partnership debts is limited to the amount of money or other property that the partner contributed or is required to contribute to the partnership. Some members of other entities, such as domestic or foreign business trusts or limited liability companies that are classified as partnerships, may be treated as limited partners for certain purposes. See, for example, Temporary Regulations section 1.469-5T(e)(3), which treats all members with limited liability as limited partners for purposes of section 469(h)(2).

Limited Partnership

A limited partnership is formed under a state limited partnership law and composed of at least one general partner and one or more limited partners.

Limited Liability Partnership

A limited liability partnership (LLP) is formed under a state limited liability partnership law. Generally, a partner in an LLP is not personally liable for the debts of the LLP or any other partner, nor is a partner liable for the acts or omissions of any other partner, solely by reason of being a partner.

Limited Liability Company

A limited liability company (LLC) is an entity formed under state law by filing articles of organization as an LLC. Unlike a partnership, none of the members of an LLC are personally liable for its debts. An LLC may be classified for federal income tax purposes as a partnership, a corporation, or an entity disregarded as an entity separate from its owner by applying the rules in Regulations section 301.7701-3. See Form 8832, Entity Classification Election, for more details.

Note. A domestic LLC with at least two members that does not file Form 8832 is classified as a partnership for federal income tax purposes.

WHEN TO FILE

Generally, a domestic partnership must file Form 1065 by the 15th day of the 4th month following the date its tax year ended as shown at the top of Form 1065.

Extension of Time to File

File Form 7004 to request a 5-month extension of time to file. File Form 7004 by the regular due date of the partnership return. Form 7004 can be electronically filed.

Period Covered

Form 1065 is an information return for calendar year 2010 and fiscal years beginning in 2010 and ending in 2011. If the return is for a fiscal year or a short tax year, fill in the tax year space at the top of Form 1065 and each Schedule K-1.

The 2010 Form 1065 may also be used if:

1. The partnership has a tax year of less than 12 months that begins and ends in 2011 and
2. The 2011 Form 1065 is not available by the time the partnership is required to file its return.

However, the partnership must show its 2011 tax year on the 2010 Form 1065 and incorporate any tax law changes that are effective for tax years beginning after 2010.

WHO MUST SIGN

General Partner or LLC Member Manager

Form 1065 is not considered to be a return unless it is signed. One general partner or LLC member manager must sign the return. Where a return is made for a partnership by a receiver, trustee or assignee, the fiduciary must sign the return, instead of the general partner or LLC member manager. Returns and forms signed by a receiver or trustee in bankruptcy on behalf of a partnership must be accompanied by a copy of the order or instructions of the court authorizing signing of the return or form.

PENALTIES

Late Filing of Return

A penalty is assessed against the partnership if it is required to file a partnership return and it (a) fails to file the return by the due date, including extensions or (b) files a return that fails to show all the information required, unless such failure is due to reasonable cause. If the failure is due to reasonable cause, attach an explanation to the partnership return. The penalty is \$195 for each month or part of a month (for a maximum of 12 months) the failure continues, multiplied by the total number of persons who were partners in the partnership during any part of the partnership's tax year for which the return is due.

Failure to Furnish Information Timely

For each failure to furnish Schedule K-1 to a partner when due and each failure to include on Schedule K-1 all the information required to be shown (or the inclusion of incorrect information), a \$100 penalty may be imposed with respect to each Schedule K-1 for which a failure occurs. The maximum penalty is \$1.5 million for all such failures during a calendar year. If the requirement to report correct information is intentionally disregarded, each \$100 penalty is increased to \$250 or, if greater, 10% of the aggregate amount of items required to be reported, and the \$1.5 million maximum does not apply.

ACCOUNTING METHODS

An accounting method is a set of rules used to determine when and how income and expenditures are reported. Figure ordinary business income using the method of accounting regularly used in keeping the partnership's books and records. In all cases, the method used must clearly reflect income.

Generally, permissible methods include:

- Cash,
- Accrual, or
- Any other method authorized by the Internal Revenue Code.

Generally, a partnership may not use the cash method of accounting if (a) it has at least one corporate partner, average annual gross receipts of more than \$5 million, and it is not a farming business or (b) it is a tax shelter (as defined in section 448(d)(3)). See section 448 for details.

Accrual method. If inventories are required, an accrual method of accounting must be used for sales and purchases of merchandise. However, qualifying taxpayers and eligible businesses of qualifying small business taxpayers are excepted from using an accrual method and may account for inventorable items as materials and supplies that are not incidental.

Under the accrual method, an amount is includible in income when:

1. All the events have occurred that fix the right to receive the income, which is the earliest of the date:
 - Payment is earned through the required performance,
 - Payment is due to the taxpayer, or
 - Payment is received by the taxpayer and
2. The amount can be determined with reasonable accuracy.

See Regulations section 1.451-1(a) for details.

Generally, an accrual basis taxpayer can deduct accrued expenses in the tax year in which:

- All events that determine the liability have occurred,
- The amount of the liability can be figured with reasonable accuracy, and
- Economic performance takes place with respect to the expense.

For property and service liabilities, for example, economic performance occurs as the property or service is provided. There are special economic performance rules for certain items, including recurring expenses. See section 461(h) and the related regulations for the rules for determining when economic performance takes place.

Nonaccrual experience method. Accrual method partnerships are not required to accrue certain amounts to be received from the performance of services that, on the basis of their experience, will not be collected, if:

- The services are in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting or
- The partnership's average annual gross receipts for the 3 prior tax years does not exceed \$5 million.

This provision does not apply to any amount if interest is required to be paid on the amount or if there is any penalty for failure to timely pay the amount.

Percentage of completion method. Long-term contracts (except for certain real property construction contracts) must generally be accounted for using the percentage of completion method described in section 460. See section 460 and the underlying regulations for rules on long-term contracts.

Mark-to-market accounting method. Dealers in securities must use the mark-to-market accounting method described in section 475. Under this method, any security that is inventory to the dealer must be included in inventory at its fair market value (FMV). Any security that is not inventory and that is held at the close of the tax year is treated as sold at its FMV on the last business day of the tax year, and any gain or loss

must be taken into account in determining gross income. The gain or loss taken into account is generally treated as ordinary gain or loss.

Dealers in commodities and traders in securities and commodities can elect to use the mark-to-market accounting method. To make the election, the partnership must file a statement describing the election, the first tax year the election is to be effective, and, in the case of an election for traders in securities or commodities, the trade or business for which the election is made. Except for new taxpayers, the statement must be filed by the due date (not including extensions) of the income tax return for the tax year immediately preceding the election year and attached to that return, or, if applicable, to a request for an extension of time to file that return.

Change in accounting method. Generally, the partnership must get IRS consent to change its method of accounting used to report income (for income as a whole or for any material item). To do so, it must file Form 3115, Application for Change in Accounting Method.

Section 481(a) adjustment. The partnership may have to make an adjustment to prevent amounts of income or expenses from being duplicated. This is called a section 481(a) adjustment. The section 481(a) adjustment period is generally 1 year for a net negative adjustment and 4 years for a net positive adjustment. However, a partnership may elect to use a 1-year adjustment period for positive adjustments if the net section 481(a) adjustment for the accounting method change is less than \$25,000. The partnership must complete the appropriate lines of Form 3115 to make the election.

Include any net positive section 481(a) adjustment on page 1, line 7. If the net section 481(a) adjustment is negative, report it on Form 1065, line 20.

Note. If the partnership is filing an application for a change in accounting method filed on or after January 10, 2011, for a year of change ending on or after April 30, 2010, see Rev. Proc. 2011-14, 2011-4 I.R.B. 330.

ACCOUNTING PERIODS

A partnership is generally required to have one of the following tax years.

1. The tax year of a majority of its partners (majority tax year).
2. If there is no majority tax year, then the tax year common to all of the partnership's principal partners (partners with an interest of 5% or more in the partnership profits or capital).
3. If there is neither a majority tax year nor a tax year common to all principal partners, then the tax year that results in the least aggregate deferral of income.

Note. In determining the tax year of a partnership under 1, 2, or 3 above, the tax years of certain tax-exempt and foreign partners are disregarded. See Regulations section 1.706-1(b) for more details.

4. Some other tax year, if:
 - The partnership can establish that there is a business purpose for the tax year; or
 - The partnership elects under section 444 to have a tax year other than a required tax year by filing Form 8716, Election to Have a Tax Year Other Than a Required Tax Year. For a partnership to have this election in effect, it must make the payments required by section 7519 and file Form 8752, Required Payment or Refund Under Section 7519.

A section 444 election ends if a partnership changes its accounting period to its required tax year or some other permitted year or it is penalized for willfully failing to comply with the requirements of section 7519. If the termination results in a short tax year, type or legibly print at the top of the first page of Form 1065 for the short tax year, "SECTION 444 ELECTION TERMINATED"; or

- The partnership elects to use a 52-53 week tax year that ends with reference to either its required tax year or a tax year elected under section 444.

Change of tax year. To change its tax year or to adopt or retain a tax year other than its required tax year, the partnership must file Form 1128, Application To Adopt, Change, or Retain a Tax Year, unless the partnership is making an election under section 444.

Note. The tax year of a common trust fund must be the calendar year.

ELECTIONS MADE BY THE PARTNERSHIP

Generally, the partnership decides how to figure taxable income from its operations. For example, it chooses the accounting method and depreciation methods it will use. The partnership also makes elections under the following sections:

1. Section 179 (election to expense certain property).
2. Section 614 (definition of property – mines, wells, and other natural deposits). This election must be made before the partners figure their individual depletion allowances under section 613A(c)(7)(D).
3. Section 1033 (involuntary conversions).
4. Section 754 (manner of electing optional adjustment to basis of partnership property).

CONTRIBUTIONS TO THE PARTNERSHIP

Generally, no gain (loss) is recognized to the partnership or any of the partners when property is contributed to the partnership in exchange for an interest in the partnership. This rule does not apply to any gain realized on a transfer of property to a partnership that would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated. If, as a result of a transfer of property to a partnership, there is a direct or indirect transfer of money or other property to the transferring partner, the partner may have to recognize gain on the exchange.

The basis to the partnership of property contributed by a partner is the adjusted basis in the hands of the partner at the time it was contributed, plus any gain recognized (under section 721(b)) by the partner at that time. See section 723 for more information.

DISPOSITIONS OF CONTRIBUTED PROPERTY

Generally, if the partnership disposes of property contributed to the partnership by a partner, income, gain, loss, and deductions from that property must be allocated among the partners to take into account the difference between the property's basis and its FMV at the time of the contribution. However, if the adjusted basis of the contributed property exceeds its fair market value at the time of the contribution, the built-in loss can only be taken into account by the contributing partner. For all other partners, the basis of the property in the hands of the partnership is treated as equal to its fair market value at the time of the contribution (see section 704(c)(1)(C)).

For property contributed to the partnership, the contributing partner must recognize gain or loss on a distribution of the property to another partner within 7 years of being contributed. The gain or loss is equal to the amount that the contributing partner should have recognized if the property had been sold for its FMV when distributed, because of the difference between the property's basis and its FMV at the time of contribution.

See section 704(c) for details and other rules on dispositions of contributed property. See section 724 for the character of any gain or loss recognized on the disposition of unrealized receivables, inventory items, or capital loss property contributed to the partnership by a partner.

RECOGNITION OF PRECONTRIBUTION GAIN ON CERTAIN PARTNERSHIP DISTRIBUTIONS

A partner who contributes appreciated property to the partnership must include in income any precontribution gain to the extent the FMV of other property (other than money) distributed to the partner by the partnership exceeds the adjusted basis of his or her partnership interest just before the distribution. Precontribution gain is the net gain, if any, that would have been recognized under section 704(c)(1)(B) if the partnership had distributed to another partner all the property that had been contributed to the partnership by the distributee partner within 7 years of the distribution and that was held by the partnership just before the distribution.

Appropriate basis adjustments are to be made to the adjusted basis of the distributee partner's interest in the partnership and the partnership's basis in the contributed property to reflect the gain recognized by the partner.

UNREALIZED RECEIVABLES AND INVENTORY ITEMS

Generally, if a partner sells or exchanges a partnership interest where unrealized receivables or inventory items are involved, the transferor partner must notify the partnership, in writing, within 30 days of the exchange. The partnership must then file Form 8308, Report of a Sale or Exchange of Certain Partnership Interests.

If a partnership distributes unrealized receivables or substantially appreciated inventory items in exchange for all or part of a partner's interest in other partnership property (including money), treat the transaction as a sale or exchange between the partner and

the partnership. Treat the partnership gain (loss) as ordinary business income (loss). The income (loss) is specially allocated only to partners other than the distributee partner.

If a partnership gives other property (including money) for all or part of that partner's interest in the partnership's unrealized receivables or substantially appreciated inventory items, treat the transaction as a sale or exchange of the property.

PASSIVE ACTIVITY LIMITATIONS

In general, section 469 limits the amount of losses, deductions, and credits that partners may claim from "passive activities." The passive activity limitations do not apply to the partnership. Instead, they apply to each partner's share of any income or loss and credit attributable to a passive activity. Because the treatment of each partner's share of partnership income or loss and credit depends on the nature of the activity that generated it, the partnership must report income or loss and credits separately for each activity.

The following instructions and the instructions for Schedules K and K-1 explain the applicable passive activity limitation rules and specify the type of information the partnership must provide to its partners for each activity. If the partnership has more than one activity, it must report information for each activity on an attachment to Schedules K and K-1.

Generally, passive activities include (a) activities that involve the conduct of a trade or business if the partner does not materially participate in the activity; and (b) all rental activities, regardless of the partner's participation. For exceptions, see *Activities That Are Not Passive Activities* below. The level of each partner's participation in an activity must be determined by the partner.

The passive activity rules provide that losses and credits from passive activities can generally be applied only against income and tax from passive activities. Thus, passive losses and credits cannot be applied against income from salaries, wages, professional fees, or a business in which the taxpayer materially participates; against "portfolio income;" or against the tax related to any of these types of income.

Special provisions apply to certain activities. First, the passive activity limitations must be applied separately with respect to a net loss from passive activities held through a publicly traded partnership. Second, special rules require that net income from certain activities that would otherwise be treated as passive income must be recharacterized as nonpassive income for purposes of the passive activity limitations.

To allow each partner to correctly apply the passive activity limitations, the partnership must report income or loss and credits separately for each of the following types of activities and income: trade or business activities, rental real estate activities, rental activities other than rental real estate, and portfolio income.

Activities That Are Not Passive Activities

The following are not passive activities.

1. Trade or business activities in which the partner materially participated for the tax year.
2. Any rental real estate activity in which the partner materially participated if the partner met both of the following conditions for the tax year:
 - a. More than half of the personal services the partner performed in trades or businesses were performed in real property trades or businesses in which he or she materially participated.
 - b. The partner performed more than 750 hours of services in real property trades or businesses in which he or she materially participated.

Note. For a partner that is a closely held C corporation (defined in section 465(a)(1)(B)), the above conditions are treated as met if more than 50% of the corporation's gross receipts are from real property trades or businesses in which the corporation materially participated.

For purposes of this rule, each interest in rental real estate is a separate activity, unless the partner elects to treat all interests in rental real estate as one activity.

If the partner is married filing jointly, either the partner or his or her spouse must separately meet both of the above conditions, without taking into account services performed by the other spouse.

A real property trade or business is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Services the partner performed as an employee are not treated as performed in a real property trade or business unless he or she owned more than 5% of the stock (or more than 5% of the capital or profits interest) in the employer.

3. An interest in an oil or gas well drilled or operated under a working interest if at any time during the tax year the partner held the working interest directly or through an entity that did not limit the partner's liability (for example, an interest as a general partner). This exception applies regardless of whether the partner materially participated for the tax year.
4. The rental of a dwelling unit used by a partner for personal purposes during the year for more than the greater of 14 days or 10% of the number of days that the residence was rented at fair rental value.
5. An activity of trading personal property for the account of owners of interests in the activity. For purposes of this rule, personal property means property that is actively traded, such as stocks, bonds, and other securities.

Trade or Business Activities

A trade or business activity is an activity (other than a rental activity or an activity treated as incidental to an activity of holding property for investment) that:

1. Involves the conduct of a trade or business (within the meaning of section 162),
2. Is conducted in anticipation of starting a trade or business, or
3. Involves research or experimental expenditures deductible under section 174 (or that would be if you chose to deduct rather than capitalize them).

If the partner does not materially participate in the activity, a trade or business activity held through a partnership is generally a passive activity of the partner.

Each partner must determine if they materially participated in an activity. As a result, while the partnership's overall trade or business income (loss) is reported on page 1 of Form 1065, the specific income and deductions from each separate trade or business activity must be reported on attachments to Form 1065. Similarly, while each partner's allocable share of the partnership's overall trade or business income (loss) is reported in box 1 of Schedule K-1, each partner's allocable share of the income and deductions from each trade or business activity must be reported on attachments to each Schedule K-1.

Portfolio Income

Generally, portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business, that is attributable to interest; dividends; royalties; income from a real estate investment trust, a regulated investment company, a real estate mortgage investment conduit, a common trust fund, a controlled foreign corporation, a qualified electing fund, or a cooperative; income from the disposition of property that produces income of a type defined as portfolio income; and income from the disposition of property held for investment. See *Self-Charged Interest* for an exception.

Solely for purposes of the preceding paragraph, gross income derived in the ordinary course of a trade or business includes (and portfolio income, therefore, does not include) only the following types of income:

- Interest income on loans and investments made in the ordinary course of a trade or business of lending money.
- Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business.
- Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies.
- Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (unless the dealer held the property for investment at any time before such income or gain is recognized).
- Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property.
- Amounts included in the gross income of a patron of a cooperative by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron.

- Other income identified by the IRS as income derived by the taxpayer in the ordinary course of a trade or business.

Report portfolio income and related deductions on Schedule K rather than on page 1 of Form 1065.

Passive Activity Reporting Requirements

To allow partners to correctly apply the passive activity loss and credit rules, any partnership that carries on more than one activity must:

1. Provide an attachment for each activity conducted through the partnership that identifies the type of activity conducted (trade or business, rental real estate, rental activity other than rental real estate, or investment).
2. On the attachment for each activity, provide a statement, using the same box numbers as shown on Schedule K-1, detailing the net income (loss), credits, and all items required to be separately stated under section 702(a) from each trade or business activity, from each rental real estate activity, from each rental activity other than a rental real estate activity, and from investments.
3. Identify the net income (loss) and credits from each oil or gas well drilled or operated under a working interest that any partner (other than a partner whose only interest in the partnership during the year is as a limited partner) holds through the partnership. Further, if any partner had an interest as a general partner in the partnership during less than the entire year, the partnership must identify both the disqualified deductions from each well that the partner must treat as passive activity deductions, and the ratable portion of the gross income from each well that the partner must treat as passive activity gross income.
4. Identify the net income (loss) and the partner's share of partnership interest expense from each activity of renting a dwelling unit that any partner uses for personal purposes during the year for more than the greater of 14 days or 10% of the number of days that the residence is rented at fair rental value.
5. Identify the net income (loss) and the partner's share of partnership interest expense from each activity of trading personal property conducted through the partnership.
6. For any gain (loss) from the disposition of an interest in an activity or of an interest in property used in an activity (including dispositions before 1987 from which gain is being recognized after 1986):
 - a. Identify the activity in which the property was used at the time of disposition,
 - b. If the property was used in more than one activity during the 12 months preceding the disposition, identify the activities in which the property was used and the adjusted basis allocated to each activity, and
 - c. For gains only, if the property was substantially appreciated at the time of the disposition and the applicable holding period specified in Regulations section 1.469-2(c)(2)(iii)(A) was not satisfied, identify the amount of the nonpassive gain and indicate whether the gain is investment income under the provisions of Regulations section 1.469-2(c)(2)(iii)(F).
7. Specify the amount of gross portfolio income, the interest expense properly allocable to portfolio income, and expenses other than interest expense that are clearly and directly allocable to portfolio income.

8. Identify separately any of the following types of payments to partners.
 - a. Payments to a partner for services other than in the partner's capacity as a partner under section 707(a).
 - b. Guaranteed payments to a partner for services under section 707(c).
 - c. Guaranteed payments for use of capital.
 - d. If section 736(a)(2) payments are made for unrealized receivables or for goodwill, the amount of the payments and the activities to which the payments are attributable.
 - e. If section 736(b) payments are made, the amount of the payments and the activities to which the payments are attributable.
9. Identify the ratable portion of any section 481 adjustment (whether a net positive or a net negative adjustment) allocable to each partnership activity.
10. Identify the amount of gross income from each oil or gas property of the partnership.
11. Identify any gross income from sources that are specifically excluded from passive activity gross income, including:
 - a. Income from intangible property if the partner is an individual and the partner's personal efforts significantly contributed to the creation of the property,
 - b. Income from state, local, or foreign income tax refunds, and
 - c. Income from a covenant not to compete (in the case of a partner who is an individual and who contributed the covenant to the partnership).
12. Identify any deductions that are not passive activity deductions.
13. If the partnership makes a full or partial disposition of its interest in another entity, identify the gain (loss) allocable to each activity conducted through the entity, and the gain allocable to a passive activity that would have been recharacterized as nonpassive gain had the partnership disposed of its interest in property used in the activity (because the property was substantially appreciated at the time of the disposition, and the gain represented more than 10% of the partner's total gain from the disposition).
14. Identify the following items from activities that may be subject to the recharacterization rules under Temporary Regulations section 1.469-2T(f) and Regulations section 1.469-2(f).
 - a. Net income from an activity of renting substantially nondepreciable property.
 - b. The smaller of equity-financed interest income or net passive income from an equity-financed lending activity.
 - c. Net rental activity income from property that was developed (by the partner or the partnership), rented, and sold within 12 months after the rental of the property commenced.
 - d. Net rental activity income from the rental of property by the partnership to a trade or business activity in which the partner had an interest (either directly or indirectly).
 - e. Net royalty income from intangible property if the partner acquired the partner's interest in the partnership after the partnership created the intangible property or performed substantial services, or incurred substantial costs in developing or marketing the intangible property.
15. Identify separately the credits from each activity conducted by or through the partnership.

16. Identify the partner's distributive share of the partnership's self-charged interest income or expense (see Self-Charged Interest).
- a. **Loans between a partner and the partnership.** Identify the lending or borrowing partner's share of the self-charged interest income or expense. If the partner made the loan to the partnership, also identify the activity in which the loan proceeds were used. If the loan proceeds were used in more than one activity, allocate the interest to each activity based on the amount of the proceeds used in each activity.
 - b. **Loans between the partnership and another partnership or an S corporation.** If the partnership's partners have the same proportional ownership interest in the partnership and the other partnership or S corporation, identify each partner's share of the interest income or expense from the loan. If the partnership was the borrower, also identify the activity in which the loan proceeds were used. If the loan proceeds were used in more than one activity, allocate the interest to each activity based on the amount of the proceeds used in each activity.

III. Specific Instructions

Line 1a. Gross Receipts or Sales

Enter the gross receipts or sales from all trade or business operations except those that must be reported on lines 4 through 7. For example, do not include gross receipts from farming on this line. Instead, show the net profit (loss) from farming on line 5. Also, do not include on line 1a rental activity income or portfolio income.

Installment sales. Generally, the installment method cannot be used for dealer dispositions of property. A "dealer disposition" is any disposition of:

1. Personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan or
2. Real property held for sale to customers in the ordinary course of the taxpayer's trade or business.

Exception. These restrictions on using the installment method do not apply to dispositions of property used or produced in a farming business or sales of timeshares and residential lots. However, if the partnership elects to report dealer dispositions of timeshares and residential lots on the installment method, each partner's tax liability must be increased by the partner's allocable share of the interest payable under section 453(l)(3).

Enter on line 1a the gross profit on collections from installment sales for any of the following:

- Dealer dispositions of property before March 1, 1986.
- Dispositions of property used or produced in the trade or business of farming.
- Certain dispositions of timeshares and residential lots reported under the installment method.

Attach a statement showing the following information for the current year and the 3 preceding years:

- Gross sales.
- Cost of goods sold.
- Gross profits.
- Percentage of gross profits to gross sales.
- Amount collected.
- Gross profit on the amount collected.

Line 2. Cost of Goods Sold

See the instructions for Schedule A, later.

Line 4. Ordinary Income (Loss) From Other Partnerships, Estates, and Trusts

Enter the ordinary income (loss) shown on Schedule K-1 (Form 1065) or Schedule K-1 (Form 1041), or other ordinary income (loss) from a foreign partnership, estate, or trust. Show the partnership's, estate's, or trust's name, address, and EIN on a separate statement attached to this return. If the amount entered is from more than one source, identify the amount from each source.

Do not include portfolio income or rental activity income (loss) from other partnerships, estates, or trusts on this line. Instead, report these amounts on Schedules K and K-1, or on line 20a of Form 8825 if the amount is from a rental real estate activity.

Ordinary income (loss) from another partnership that is a publicly traded partnership is not reported on this line. Instead, report the amount separately on line 11 of Schedule K and in box 11 of Schedule K-1 using code F.

Treat shares of other items separately reported on Schedule K-1 issued by the other entity as if the items were realized or incurred by this partnership.

If there is a loss from another partnership, the amount of the loss that may be claimed is subject to the at-risk and basis limitations as appropriate.

If the tax year of your partnership does not coincide with the tax year of the other partnership, estate, or trust, include the ordinary income (loss) from the other entity in the tax year in which the other entity's tax year ends.

Line 5. Net Farm Profit (Loss)

Enter the partnership's net farm profit (loss) from Schedule F (Form 1040), Profit or Loss From Farming. Attach Schedule F (Form 1040) to Form 1065. Do not include on this line any farm profit (loss) from other partnerships. Report those amounts on line 4. In figuring the partnership's net farm profit(loss), do not include any section 179 expense deduction; this amount must be separately stated.

Also report the partnership's fishing income on this line.

Line 6. Net Gain (Loss) From Form 4797

Caution. Include only ordinary gains or losses from the sale, exchange, or involuntary conversion of assets used in a trade or business activity. Ordinary gains or losses from the sale, exchange, or involuntary conversion of rental activity assets are reported separately on line 19 of Form 8825 or line 3c of Schedule K and box 3 of Schedule K-1, generally as a part of the net income (loss) from the rental activity.

A partnership that is a partner in another partnership must include on Form 4797, Sales of Business Property, its share of ordinary gains (losses) from sales, exchanges, or involuntary conversions (other than casualties or thefts) of the other partnership's trade or business assets.

Partnerships should not use Form 4797 to report the sale or other disposition of property if a section 179 expense deduction was previously passed through to any of its partners for that property. Instead, report it in box 20 of Schedule K-1 using code L.

Line 7. Other Income (Loss)

Enter on line 7 trade or business income (loss) that is not included on lines 1a through 6. List the type and amount of income on an attached statement. Examples of such income include:

1. Interest income derived in the ordinary course of the partnership's trade or business, such as interest charged on receivable balances.
2. Recoveries of bad debts deducted in prior years under the specific charge-off method.
3. Taxable income from insurance proceeds.
4. The amount included in income from line 7 of Form 6478, Alcohol and Cellulosic Biofuel Fuels Credit.
5. The amount included in income from line 8 of Form 8864, Biodiesel and Renewable Diesel Fuels Credit.
6. The recapture amount for section 280F if the business use of listed property drops to 50% or less. To figure the recapture amount, the partnership must complete Part IV of Form 4797.
7. Any recapture amount under section 179A for certain clean-fuel vehicle property (or clean-fuel refueling property) that ceases to qualify.
8. All section 481 income adjustments resulting from changes in accounting methods. Show the computation of the section 481 adjustments on an attached statement.
9. Part of all of the proceeds received from certain employer-owned life insurance contracts issued after August 17, 2006. Partnerships that own one or more employer-owned life insurance contracts issued after this date must file Form 8925, Report of Employer-Owned Life Insurance contracts. See section 101(j) for details.

Do not include items requiring separate computations that must be reported on Schedules K and K-1.

Do not report portfolio or rental activity income (loss) on this line.

DEDUCTIONS

Do not report the following expenses on lines 9 through 20:

- Rental activity expenses. Report these expenses on Form 8825 or line 3b of Schedule K.
- Deductions allocable to portfolio income. Report these deductions on line 13d of Schedule K and in box 13 of Schedule K-1 using code I, K or L.
- Nondeductible expenses (for example, expenses connected with the production of tax-exempt income). Report nondeductible expenses on line 18c of Schedule K and in box 18 of Schedule K-1 using code C.
- Qualified expenditures to which an election under section 59(e) may apply. The instructions for line 13c of Schedule K and for Schedule K-1, box 13, code J, explain how to report these amounts.
- Items the partnership must state separately that require separate computations by the partners. Examples include expenses incurred for the production of income instead of in a trade or business, charitable contributions, foreign taxes paid, intangible drilling and development costs, soil and water conservation expenditures, amortizable basis of reforestation expenditures, and exploration expenditures. The distributive shares of these expenses are reported separately to each partner on Schedule K-1.

Limitations on Deductions

Section 263A uniform capitalization rules. The uniform capitalization rules of section 263A require partnerships to capitalize or include in inventory costs, certain costs incurred in connection with the following.

- The production of real and tangible personal property held in inventory or held for sale in the ordinary course of business.
- Real property or personal property (tangible and intangible) acquired for resale.
- The production of real property and tangible personal property by a partnership for use in its trade or business or in an activity engaged in for profit.

The costs required to be capitalized under section 263A are not deductible until the property to which the costs relate is sold, used, or otherwise disposed of by the partnership.

Indirect costs. Partnerships subject to the uniform capitalization rules are required to capitalize not only direct costs but an allocable part of most indirect costs (including taxes) that benefit the assets produced or acquired for resale, or are incurred by reason of the performance of production or resale activities.

For inventory, some of the indirect costs that must be capitalized are:

- Administration expenses.
- Taxes.
- Depreciation.
- Insurance.
- Compensation paid to officers attributable to services.

- Rework labor.
- Contributions to pension, stock bonus, and certain profit-sharing, annuity, or deferred compensation plans.

Regulations section 1.263A-1(e)(3) specifies other indirect costs that relate to production or resale activities that must be capitalized and those that may be currently deductible.

Interest expense paid or incurred during the production period of designated property must be capitalized and is governed by special rules.

Transactions between related taxpayers. Generally, an accrual basis partnership can deduct business expenses and interest owed to a related party (including any partner) only in the tax year of the partnership that includes the day on which the payment is includible in the income of the related party.

Business start-up and organizational costs. Generally, a partnership can elect to deduct up to \$5,000 of business start-up and organizational costs paid or incurred after October 22, 2004. Any remaining costs must be amortized. The \$5,000 deduction is reduced (but not below zero) by the amount the total costs exceed \$50,000. If the total costs are \$55,000 or more, the deduction is reduced to zero. Any costs not deducted must be amortized as explained below. See sections 195(b) and 248(a).

Special rule for 2010 start-up costs. For a tax year beginning in 2010, a partnership can elect to deduct up to \$10,000 of business start-up costs paid or incurred after December 31, 2009. The \$10,000 deduction is reduced (but not below zero) by the amount such start-up costs exceed \$60,000. Any remaining costs must be amortized. See section 195(b)(3).

Note. For start-up and organizational costs paid or incurred after September 8, 2008, the partnership is not required to attach a statement or specifically identify the amount deducted for the election under sections 195(b) and 709(b) to be effective. It is a deemed election. Whether a partnership deducts a portion of its start-up and organizational costs under Temporary Regulations section 1.195-1T and 1.709-1T or elects to amortize the full amount of such costs, its election is irrevocable.

For start-up and organizational costs paid or incurred after October 22, 2004, and before September 9, 2008, a partnership generally must attach the statement required by Regulations section 1.195-1(b) and 1.709-1(c) to make the election to deduct a portion of such costs (as explained above). This election is irrevocable. However, a partnership can apply the provisions of these temporary regulations to costs paid or incurred after October 22, 2004, provided the period of limitations on assessment has not expired for the year of election.

Amortization. Any costs not deducted under the above rules must be amortized ratably over a 180-month period, beginning with the month the partnership begins business. See the Instructions for Form 4562 for details.

Report the deductible amount of these costs and any amortization on line 20. For amortization that began during the tax year, complete and attach Form 4562.

Syndication costs. Costs for issuing and marketing interests in the partnership, such as commissions, professional fees, and printing costs, must be capitalized. They cannot be depreciated or amortized. See the instructions for line 10 for the treatment of syndication fees paid to a partner.

Reducing certain expenses for which credits are allowable. The partnership may need to reduce the otherwise allowable deductions for expenses used to figure certain credits. The following are examples of such credits. (Do not reduce the amount of the allowable deduction for any portion of the credit that was passed through to the partnership from another pass-through entity).

1. Work opportunity credit.
2. Credit for increasing research activities.
3. Disabled access credit.
4. Empowerment zone employment credit.
5. Indian employment credit.
6. Credit for employer social security and Medicare taxes paid on certain employee tips.
7. Orphan drug credit.
8. Credit for small employer pension plan startup costs.
9. Credit for employer-provided childcare facilities and services.
10. Low sulfur diesel fuel production credit.
11. Mine rescue team training credit.
12. Agricultural chemicals security credit.
13. Credit for employer differential wage payments.
14. Credit for small employer health insurance premiums.

If the partnership has any of these credits, figure each current year credit before figuring the deductions for expenses on which the credit is based.

Line 9. Salaries and Wages

Enter the salaries and wages paid or incurred for the tax year, reduced by the amount of the following credits:

- Form 5884, Work Opportunity Credit;
- Form 8844, Empowerment Zone Employment Credit;
- Form 8845, Indian Employment Credit;
- Form 8923, Mine Rescue Team Training Credit; and
- Form 8932, Credit for Employer Differential Wage Payments.

Do not reduce the amount of the allowable deduction for any portion of the credit that was passed through to the partnership from another pass-through entity. See the instructions for these forms for more information.

Do not include salaries and wages reported elsewhere on the return, such as amounts included in cost of goods sold, elective contributions to a section 401(k) cash or deferred arrangement, or amounts contributed under a salary reduction SEP agreement or a SIMPLE IRA plan.

Line 10. Guaranteed Payments to Partners

Deduct payments or credits to a partner for services or for the use of capital if the payments or credits are determined without regard to partnership income and are allocable to a trade or business activity. Also include on line 10 amounts paid during the tax year for insurance that constitutes medical care for a partner, a partner's spouse, a partner's dependents, or any children under age 27 who are not dependents.

Do not include any payments and credits that should be capitalized. For example, although payments or credits to a partner for services rendered in organizing or syndicating a partnership may be guaranteed payments, they are not deductible on line 10. They are capital expenditures. However, they should be separately reported on Schedule K, line 4 and on Schedule K-1, box 4.

Do not include distributive shares of partnership profits.

Report the guaranteed payments to the appropriate partners on Schedule K-1, box 4.

Line 11. Repairs and Maintenance

Enter the costs of incidental repairs and maintenance that do not add to the value of the property or appreciably prolong its life, but only to the extent that such costs relate to a trade or business activity and are not claimed elsewhere on the return.

The cost of new buildings, machinery, or permanent improvements that increase the value of the property are not deductible. They are chargeable to capital accounts and may be depreciated or amortized.

Line 12. Bad Debts

Enter the total debts that became worthless in whole or in part during the year, but only to the extent such debts relate to a trade or business activity. Report deductible nonbusiness bad debts as a short-term capital loss on Schedule D or Schedule D-1 (Form 1065).

Caution. *Cash method partnerships cannot take a bad debt deduction unless the amount was previously included in income.*

Line 13. Rent

Enter rent paid on business property used in a trade or business activity. Do not deduct rent for a dwelling unit occupied by any partner for personal use.

If the partnership rented or leased a vehicle, enter the total annual rent or lease expense paid or incurred in the trade or business activities of the partnership. Also complete Part V of Form 4562, Depreciation and Amortization. If the partnership leased a vehicle for a term of 30 days or more, the deduction for vehicle lease expense may have to be reduced by an amount called the inclusion amount. You may have an inclusion amount if:

The lease term began:	And the vehicle's FMV on the first day of the lease exceeded:
After 12/31/07 but before 1/1/11	\$18,500
After 12/31/06 but before 1/1/08	\$15,500
After 12/31/04 but before 1/1/07	\$15,200
After 12/31/03 but before 1/1/05	\$17,500

If the lease term began before January 1, 2004, see Pub. 463, Travel, Entertainment, Gift, and Car Expenses, to find out if the partnership has an inclusion amount. The inclusion amount for lease terms beginning in 2011 will be published in the Internal Revenue Bulletin in early 2011.

Line 14. Taxes and Licenses

Enter taxes and licenses paid or incurred in the trade or business activities of the partnership if not reflected elsewhere on the return. Federal import duties and federal excise and stamp taxes are deductible only if paid or incurred in carrying on the trade or business of the partnership.

Do not deduct the following taxes on line 14.

- Taxes not imposed on the partnership.
- Federal income taxes or taxes reported elsewhere on the return.
- Section 901 foreign taxes. Report these taxes separately on Schedule K, line 16l and on Schedule K-1, box 16, using codes L and M.
- Taxes allocable to a rental activity. Taxes allocable to a rental real estate activity are reported on Form 8825. Taxes allocable to a rental activity other than a rental real estate activity are reported on line 3b of Schedule K.
- Taxes allocable to portfolio income. These taxes are reported on line 13d of Schedule K and in box 13 of Schedule K-1 using code K.
- Taxes paid or incurred for the production or collection of income, or for the management, conservation, or maintenance of property held to produce income. Report these taxes separately on line 13d of Schedule K and in box 13 of Schedule K-1 using code W.

See section 263A(a) for rules on capitalization of allocable costs (including taxes) for any property.

- Taxes, including state or local sales taxes, that are paid or incurred in connection with an acquisition or disposition of property (these taxes must be treated as a part of the cost of the acquired property or, in the case of a disposition, as a reduction in the amount realized on the disposition).
- Taxes assessed against local benefits that increase the value of the property assessed (such as for paving, etc.).

See section 164(d) for apportionment of taxes on real property between seller and purchaser.

Line 15. Interest

Include only interest incurred in the trade or business activities of the partnership that is not claimed elsewhere on the return.

Do not include interest expense on the following:

- Debt used to purchase rental property or debt used in a rental activity. Interest allocable to a rental real estate activity is reported on Form 8825 and is used in arriving at net income (loss) from rental real estate activities on line 2 of Schedule K and in box 2 of Schedule K-1. Interest allocable to a rental activity other than a rental real estate activity is included on line 3b of Schedule K and is used in arriving at net income (loss) from a rental activity (other than a rental real estate activity). This net amount is reported on line 3c of Schedule K and in box 3 of Schedule K-1.
- Debt used to buy property held for investment. Interest that is clearly and directly allocable to interest, dividend, royalty, or annuity income not derived in the ordinary course of a trade or business is reported on line 13b of Schedule K and in box 13 of Schedule K-1 using code H. See the instructions for line 13b of Schedule K; box 13, code H of Schedule K-1; and Form 4952, Investment Interest Expense Deduction, for more information on investment property.
- Debt proceeds allocated to distributions made to partners during the tax year. Instead, report such interest on line 13d of Schedule K and in box 13 of Schedule K-1 using code W. To determine the amount to allocate to distributions to partners, see Notice 89-35, 1989-1 C.B. 675.
- Debt required to be allocated to the production of designated property. Designated property includes real property, personal property that has a class life of 20 years or more, and other tangible property requiring more than 2 years (1 year in the case of property with a cost of more than \$1 million) to produce or construct. Interest allocable to designated property produced by a partnership for its own use or for sale must be capitalized. In addition, a partnership must also capitalize any interest on debt allocable to an asset used to produce designated property. A partner may have to capitalize interest that the partner incurs during the tax year for the partnership's production expenditures. Similarly, interest incurred by a partnership may have to be capitalized by a partner for the partner's own production expenditures. The information required by the partner to properly capitalize interest for this purpose must be provided by the partnership on an attachment for box 20 of Schedule K-1, using code R. See section 263A(f) and Regulations sections 1.263A-8 through 1.263A-15.

Special rules apply to:

- Allocating interest expense among activities so that the limitations on passive activity losses, investment interest, and personal interest can be properly figured. Generally, interest expense is allocated in the same manner as debt is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. Temporary Regulations section 1.163-8T gives rules for tracing debt proceeds to expenditures.
- Interest paid by a partnership to a partner for the use of capital, which should be entered on line 10 as guaranteed payments.

- Prepaid interest, which generally can only be deducted over the period to which the prepayment applies. See section 461(g) for details.
- Interest which is allocable to unborrowed policy cash values of life insurance, endowment, or annuity contracts issued after June 8, 1997, when the partnership is a policyholder or beneficiary. See section 264(f). Attach a statement showing the computation of the deduction.

Line 16. Depreciation

On line 16a, enter only the depreciation claimed on assets used in a trade or business activity. Enter on line 16b the depreciation reported elsewhere on the return (for example, on Schedule A) that is attributable to assets used in trade or business activities. See the Instructions for Form 4562 or Pub. 946, How To Depreciate Property, to figure the amount of depreciation to enter on this line.

Complete and attach Form 4562 only if the partnership placed property in service during the tax year or claims depreciation on any car or other listed property.

Do not include any section 179 expense deduction on this line. This amount is not deducted by the partnership. Instead, it is passed through to the partners in box 12 of Schedule K-1. However, reduce the basis of any asset of the partnership by the amount of section 179 expense elected by the partnership, even if a portion of that amount cannot be passed through to its partners this year and must be carried forward because of limitations at the partnership level.

Line 17. Depletion

If the partnership claims a deduction for timber depletion, complete and attach Form T, Forest Activities Schedule.

Caution. Do not deduct depletion for oil and gas properties. Each partner figures depletion on oil and gas properties. See the instructions for Schedule K-1, box 20, "Information needed to figure depletion—oil and gas (code T)," for the information on oil and gas depletion that must be supplied to the partners by the partnership.

Line 18. Retirement Plans, etc.

Do not deduct payments for partners to retirement or deferred compensation plans including IRAs, qualified plans, and simplified employee pension (SEP) and SIMPLE IRA plans on this line. These amounts are reported on Schedule K-1, box 13, using code R, and are deducted by the partners on their own returns.

Enter the deductible contributions not claimed elsewhere on the return made by the partnership for its common-law employees under a qualified pension, profit-sharing, annuity, or SEP or SIMPLE IRA plan, and under any other deferred compensation plan.

If the partnership contributes to an individual retirement arrangement (IRA) for employees, include the contribution in salaries and wages on page 1, line 9, or Schedule A, line 3, and not on line 18.

Employers who maintain a pension, profit-sharing, or other funded deferred compensation plan (other than a SEP or SIMPLE IRA), whether or not the plan is qualified under the Internal Revenue Code and whether or not a deduction is claimed for the current year, generally must file the applicable form listed below.

- Form 5500, Annual Return/Report of Employee Benefit Plan. File this form for a plan that is not a one-participant plan (see below).
- Form 5500-SF, Short Form Annual Return/Report of Small Employee Benefit Plan (generally filed instead of Form 5500 if there are under 100 participants at the beginning of the plan year).

Note. Form 5500 and 5500-SF must be filed electronically under the computerized ERISA Filing Acceptance System (EFAST2).

- Form 5500-EZ, Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan. File this form for a plan that only covers one or more partners (or partners and their spouses).

Line 19. Employee Benefit Programs

Enter the partnership's contributions to employee benefit programs not claimed elsewhere on the return (for example, insurance, health, and welfare programs) that are not part of a pension, profit-sharing, etc., plan included on line 18.

Do not include amounts paid during the tax year for insurance that constitutes medical care for a partner, a partner's spouse, a partner's dependents, or any children under age 27 who are not dependents. Instead, include these amounts on line 10 as guaranteed payments and on Schedule K, line 4, and Schedule K-1, box 4, of each partner on whose behalf the amounts were paid. Also report these amounts on Schedule K, line 13d, and Schedule K-1, box 13, using code M, of each partner on whose behalf the amounts were paid.

Line 20. Other Deductions

Enter the total allowable trade or business deductions that are not deductible elsewhere on page 1 of Form 1065. Attach a statement listing by type and amount each deduction included on this line. Examples of other deductions include:

- Amortization (except as noted below). See the Instructions for Form 4562 for more information. Complete and attach Form 4562 if the partnership is claiming amortization of costs that began during the tax year.
- Insurance premiums.
- Legal and professional fees.
- Supplies used and consumed in the business.
- Utilities.
- Certain business start-up expenditures and organizational expenditures that the partnership has elected to amortize or deduct. See *Limitations on Deductions* for more details.
- Deduction for certain energy efficient commercial building property. See section 179D.
- Any negative net section 481(a) adjustment.

Also see *Special Rules* below for limits on certain other deductions.

Do not deduct on line 20:

- Items that must be reported separately on Schedules K and K-1.
- Fines or penalties paid to a government for violating any law. Report these expenses on Schedule K, line 18c.
- Expenses allocable to tax-exempt income. Report these expenses on Schedule K, line 18c.
- Net operating losses. Only individuals and corporations may claim a net operating loss deduction.
- Amounts paid or incurred to participate or intervene in any political campaign on behalf of a candidate for public office, or to influence the general public regarding legislative matters, elections, or referendums. Report these expenses on Schedule K, line 18c.
- Expenses paid or incurred to influence federal or state legislation, or to influence the actions or positions of certain federal executive branch officials. However, certain in-house lobbying expenditures that do not exceed \$2,000 are deductible. See section 162(e) for more details.

Special Rules

Commercial revitalization deduction. If the partnership constructs, purchases, or substantially rehabilitates a qualified building in a renewal community, it may qualify for a deduction of either (a) 50% of qualified capital expenditures in the year the building is placed in service or (b) amortization of 100% of the qualified capital expenditures over a 120-month period beginning with the month the building is placed in service. If the partnership elects to amortize these expenditures, complete and attach Form 4562. To qualify, the building must be nonresidential (as defined in section 168(e)(2)) and placed in service by the partnership. The partnership must be the original user of the building unless it is substantially rehabilitated. The qualified expenditures cannot exceed the lesser of \$10 million or the amount allocated to the building by the commercial revitalization agency of the state in which the building is located. Any remaining expenditures are depreciated over the regular depreciation recovery period.

Note. The commercial revitalization deduction is not available for buildings placed in service after 2009.

Rental real estate. Do not report this deduction on line 20 if the building is placed in service as rental real estate. A commercial revitalization deduction for rental real estate is not deducted by the partnership but is passed through to the partners in box 13 of Schedule K-1, using code Q.

Travel, meals, and entertainment. Subject to limitations and restrictions discussed below, a partnership can deduct ordinary and necessary travel, meals, and entertainment expenses paid or incurred in its trade or business. Also, special rules apply to deductions for gifts, skybox rentals, luxury water travel, convention expenses, and entertainment tickets.

Travel. The partnership cannot deduct travel expenses of any individual accompanying a partner or partnership employee, including a spouse or dependent of the partner or employee, unless:

- That individual is an employee of the partnership and
- His or her travel is for a bona fide business purpose and would otherwise be deductible by that individual.

Meals and entertainment. Generally, the partnership can deduct only 50% of the amount otherwise allowable for meals and entertainment expenses paid or incurred in its trade or business. In addition (subject to exceptions under section 274(k)(2)):

- Meals must not be lavish or extravagant,
- A bona fide business discussion must occur during, immediately before, or immediately after the meal, and
- A partner or employee of the partnership must be present at the meal.

See section 274(n)(3) for a special rule that applies to expenses for meals consumed by individuals subject to the hours of service limits of the Department of Transportation.

Membership dues. The partnership may deduct amounts paid or incurred for membership dues in civic or public service organizations, professional organizations (such as bar and medical associations), business leagues, trade associations, chambers of commerce, boards of trade, and real estate boards. However, no deduction is allowed if a principal purpose of the organization is to entertain, or provide entertainment facilities for, members or their guests. In addition, the partnership may not deduct membership dues in any club organized for business, pleasure, recreation, or other social purpose. This includes country clubs, golf and athletic clubs, airline and hotel clubs, and clubs operated to provide meals under conditions favorable to business discussion.

Entertainment facilities. The partnership cannot deduct an expense paid or incurred for a facility (such as a yacht or hunting lodge) used for an activity usually considered entertainment, amusement, or recreation.

Generally, the partnership may be able to deduct otherwise nondeductible meals, travel, and entertainment expenses if the amounts are treated as compensation to the recipient and reported on Form W-2 for an employee or on Form 1099-MISC for an independent contractor.

Reforestation expenditures. If the partnership made an election to deduct a portion of its reforestation expenditures on line 13d of Schedule K, it must amortize over an 84-month period the portion of these expenditures in excess of the amount deducted on Schedule K (see section 194). Deduct on line 20 only the amortization of these excess reforestation expenditures. See *Reforestation expense deduction (code S)*.

Caution. Do not deduct amortization of reforestation expenditures paid or incurred before October 23, 2004. If the partnership elected to amortize these expenditures, report the amortizable basis on line 20c of Schedule K. See *Amortization of reforestation costs (code U)*.

Schedule A. Cost of Goods Sold

Cost of Goods Sold

Generally, inventories are required at the beginning and end of each tax year if the production, purchase, or sale of merchandise is an income-producing factor.

However, if the partnership is a qualifying taxpayer or a qualifying small business taxpayer, it may adopt or change its accounting method to account for inventoriable items in the same manner as materials and supplies that are not incidental (unless its business is a tax shelter (as defined in section 448(d)(3))).

A **qualifying taxpayer** is a taxpayer that, with respect to each prior tax year ending after December 16, 1998, has average annual gross receipts of \$1 million or less for the 3-tax-year period ending with that prior tax year.

A **qualifying small business taxpayer** is a taxpayer (a) that, for each prior tax year ending on or after December 31, 2000, has average annual gross receipts of \$10 million or less for the 3-tax-year period ending with that prior tax year and (b) whose principal business activity is not an ineligible activity.

Under this accounting method, inventory costs for raw materials purchased for use in producing finished goods and merchandise purchased for resale are deductible in the year the finished goods or merchandise are sold (but not before the year the partnership paid for the raw materials or merchandise if it is also using the cash method).

Enter amounts paid for all raw materials and merchandise during the tax year on line 2. The amount the partnership can deduct for the tax year is figured on line 8.

All filers that have not elected to treat inventoriable items as materials and supplies that are not incidental should see *Section 263A uniform capitalization rules* before completing Schedule A.

Line 1. Inventory at Beginning of Year

If the partnership is changing its method of accounting for the current tax year, it must refigure last year's closing inventory using its new method of accounting and enter the result on line 1. If there is a difference between last year's closing inventory and the refigured amount, attach an explanation and take it into account when figuring the partnership's section 481(a) adjustment.

Line 2. Purchases

Reduce purchases by items withdrawn for personal use. The cost of these items should be shown on line 19b of Schedule K and in box 19 of Schedule K-1, using code C, as distributions to partners.

Line 4. Additional Section 263A Costs

An entry is required on this line only for partnerships that have elected a simplified method.

For partnerships that have elected the simplified production method, additional section 263A costs are generally those costs, other than interest, that were not capitalized under the partnership's method of accounting immediately prior to the effective date of section 263A that are required to be capitalized under section 263A. Interest must be accounted for separately. For new partnerships, additional section 263A costs are the costs, other than interest, that must be capitalized under section 263A, but which the partnership would not have been required to capitalize if it had existed before the effective date of section 263A.

For partnerships that have elected the simplified resale method, additional section 263A costs are generally those costs incurred with respect to the following categories.

- Off-site storage or warehousing;
- Purchasing;
- Handling, such as processing, assembly, repackaging, and transporting; and
- General and administrative costs (mixed service costs).

Enter on line 4 the balance of section 263A costs paid or incurred during the tax year not includable on lines 2, 3, and 5. Attach a statement listing these costs.

Line 5. Other Costs

Enter on line 5 any other inventoriable costs paid or incurred during the tax year not entered on lines 2 through 4. Attach a statement.

Line 7. Inventory at End of Year

If the partnership accounts for inventoriable items in the same manner as materials and supplies that are not incidental, enter on line 7 the portion of its raw materials and merchandise purchased for resale that are included on line 6 and were not sold during the year.

Lines 9a through 9c. Inventory Valuation Methods

Inventories can be valued at:

- Cost,
- Cost or market value (whichever is lower), or
- Any other method approved by the IRS that conforms to the requirements of the applicable regulations cited below.

However, if the partnership is using the cash method of accounting, it is required to use cost.

Partnerships that account for inventoriable items in the same manner as materials and supplies that are not incidental may currently deduct expenditures for direct labor and all indirect costs that would otherwise be included in inventory costs.

The average cost (rolling average) method of valuing inventories generally does not conform to the requirements of the regulations.

Partnerships that use erroneous valuation methods must change to a method permitted for federal tax purposes. To make this change, use Form 3115.

On line 9a, check the methods used for valuing inventories. Under lower of cost or market, the term “market” (for normal goods) means the current bid price prevailing on the inventory valuation date for the particular merchandise in the volume usually purchased by the taxpayer. For a manufacturer, market applies to the basic elements of cost – raw materials, labor, and burden. If section 263A applies to the taxpayer, the basic elements of cost must reflect the current bid price of all direct costs and all indirect costs properly allocable to goods on hand at the inventory date.

Inventory may be valued below cost when the merchandise is unsalable at normal prices or unusable in the normal way because the goods are subnormal due to damage, imperfections, shopwear, etc., within the meaning of Regulations section 1.471-2(c). These goods may be valued at the bona fide selling price, minus the direct cost of disposition (but not less than scrap value). Bona fide selling price means the price at which goods are actually offered during a period ending not later than 30 days after the inventory date.

If this is the first year the Last-in First-out (LIFO) inventory method was either adopted or extended to inventory goods not previously valued under the LIFO method, attach Form 970, Application to Use LIFO Inventory Method, or a statement with the information required by Form 970. Also check the box on line 9c.

If the partnership has changed or extended its inventory method to LIFO and has had to write up its opening inventory to cost in the year of election, report the effect of this write-up as income (line 7, page 1, Form 1065) proportionately over a 3-year period that begins in the tax year of the LIFO election.

Schedule B. Other Information

Question 1

Check box 1f for any other type of entity and state the type.

Questions 3 and 4

Constructive ownership of the partnership. For purposes of question 3, in determining an ownership interest in the profit, loss, or capital of the partnership, the constructive ownership rules of section 267(c) (excluding sections 267(c)(3)) apply to ownership of interests in the partnership as well as corporate stock. An interest in the partnership which is owned directly or indirectly by or for another entity (corporation, partnership, estate, or trust) is considered to be owned proportionately by the owners (shareholders, partners, or beneficiaries) of the owning entity.

Also, under section 267(c), an individual is considered to own an interest owned directly or indirectly by or for his or her family. The family of an individual includes only that individual's spouse, brothers, sisters, ancestors, and lineal descendants. An interest will be attributed from an individual under the family attribution rules only if the person to whom the interest is attributed owns a direct interest in the partnership or an indirect interest under section 267(c)(1) or (5). For purposes of these instructions, an individual will not be considered to own, under section 267(c)(2), an interest in the partnership owned, directly or indirectly, by a family member of the individual unless the individual also owns an interest in the partnership either directly or indirectly through a corporation, partnership, or trust.

Constructive ownership examples for questions 3 and 4 are included below. For the purposes of questions 3 and 4, add an owner's direct percentage ownership and indirect percentage ownership in an entity to determine if the owner owns, directly or indirectly, 50% or more of the entity.

Example 1. Corporation A owns, directly, an interest of 50% in the profit, loss, or capital of Partnership B. Corporation A also owns, directly, an interest of 15% in the profit, loss, or capital of Partnership C. Partnership B owns, directly, an interest of 70% in the profit, loss, or capital of Partnership C. Therefore, Corporation A owns, directly or indirectly, an interest of 50% in the profit, loss, or capital of Partnership C (15% directly and 35% indirectly through Partnership B). On Partnership C's Form 1065, it must answer "Yes" to question 3a of Schedule B.

Example 2. A owns, directly, 50% of the profit, loss, or capital of Partnership X. B, the daughter of A, does not own, directly, any interest in X and does not own, indirectly, any interest in X through any entity (corporation, partnership, trust, or estate). Because family attribution rules apply only when an individual (in this example, B) owns a direct interest in the partnership or an indirect interest through another entity, A's interest in Partnership X is not attributable to B. On Partnership X's Form 1065, it must answer "Yes" to question 3b of Schedule B.

Constructive ownership of other entities by the partnership. For purposes of determining the partnership's constructive ownership of other entities, the constructive ownership rules of section 267(c) (excluding section 267(c)(3)) apply to ownership of interests in partnerships and trusts as well as corporate stock. Generally, if an entity (a corporation, partnership, or trust) is owned, directly or indirectly, by or for another entity (corporation, partnership, estate, or trust), the owned entity is considered to be owned proportionally by or for the owners (shareholders, partners, or beneficiaries) of the owning entity.

Question 4a. List each corporation in which the partnership, at the end of the tax year, owns, directly, 20% or more, or owns, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote. Indicate the name, EIN, country of incorporation, and the percentage interest owned, directly or indirectly, in the total voting power. List the parent corporation of an affiliated group filing a consolidated tax return rather than the subsidiary members except for subsidiary members in which an interest is owned, directly or indirectly, independent of the interest owned, directly or indirectly, in the parent corporation. If a corporation is owned through a disregarded entity, list the information for the corporation rather than the disregarded entity.

Question 4b. List each partnership in which the partnership, at the end of the tax year, owns, directly, an interest of 20% or more, or owns, directly or indirectly, an interest of 50% or more in the profit, loss, or capital of the partnership. List each trust in which the partnership, at the end of the tax year, owns, directly, an interest of 20% or more, or owns, directly or indirectly, an interest of 50% or more in the trust beneficial interest. For each partnership or trust listed, indicate the name, EIN, type of entity (partnership or trust), and country of origin. If the listed entity is a partnership, enter in column (v) the maximum of percentage interests owned, directly or indirectly, in the profit, loss, or capital of the partnership at the end of the partnership's tax year. If the entity is a trust, enter in column (v) the percentage of the partnership's beneficial interest in the trust

owned, directly or indirectly, at the end of the tax year. List a partnership or trust owned through a disregarded entity rather than the disregarded entity.

Question 5

Generally, the tax treatment of partnership items is determined at the partnership level in a consolidated audit proceeding under sections 6221 and 6234, rather than in separate proceedings with individual partners. Small partnerships are not subject to the rules for consolidated audit proceedings. "Small partnerships" are defined as any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner. The small partnership exception to the consolidated audit procedures does not apply if any partner during the tax year is a partnership, estate, trust, S corporation, nominee, or disregarded entity.

Small partnerships can elect to be subject to the rules for consolidated audit proceedings by attaching Form 8893, Election of Partnership Level Tax Treatment, or an election statement to the partnership return for the first taxable year for which the election is to be effective. This election must be signed by all persons who were partners of the partnership at any time during the partnership's taxable year. Once made, the election may not be revoked without IRS consent.

Caution. *The partnership does not make this election when it answers "Yes" to question 5 or when it designates a Tax Matters Partner on Form 1065. The election must be made separately by filing Form 8893.*

Question 6

Answer "Yes" if the partnership meets all four of the requirements shown on the form. Total receipts is defined as the sum of gross receipts or sales (page 1, line 1a); all other income (page 1, lines 4 through 7); income reported on Schedule K, lines 3a, 5, 6a, and 7; income or net gain reported on Schedule K, lines 8, 9a, 10, and 11; and income or net gain reported on Form 8825, lines 2, 19, and 20a. Total assets is defined as the amount that would be reported in Item F on page 1 of Form 1065.

Question 7

Answer "Yes" if interests in the partnership are traded on an established securities market or are readily tradable on a secondary market (or its substantial equivalent).

Question 8

Generally, the partnership will have income if debt is cancelled or forgiven. The determination of the existence and amount of cancellation of debt income is made at the partnership level. Partnership cancellation of indebtedness income is separately stated on Schedule K and Schedule K-1. The extent to which such income is taxable is usually made by each individual partner under rules found in section 108. For more information, see Publication 334, Tax Guide for Small Business.

Question 9

Answer “Yes” if the partnership filed, or is required to file, a return under section 6111 to provide information on any reportable transaction by a material advisor. Use Form 8918, Material Advisor Disclosure Statement, to provide the information. For more information, see the Instructions to Form 8918.

Question 10. Foreign Accounts

Answer “Yes” if either 1 or 2 below applies to the partnership. Otherwise, check the “No” box.

1. At any time during calendar year 2010, the partnership had an interest in or signature or other authority over a bank account, securities account, or other financial account in a foreign country (see Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts); and
 - The combined value of the accounts was more than \$10,000 at any time during the calendar year; and
 - The accounts were not with a U.S. military banking facility operated by a U.S. financial institution.
2. The partnership owns more than 50% of the stock in any corporation that would answer the question “Yes” based on item 1 above.

If the “Yes” box is checked for the question:

- Enter the name of the foreign country or countries. Attach a separate sheet if more space is needed.
- File Form TD F 90-22.1 by June 30, 2010, with the Department of the Treasury at the address shown on the form.

Question 11

The partnership may be required to file Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, if:

- It directly or indirectly transferred property or money to a foreign trust. For this purpose, any U.S. person who created a foreign trust is considered a transferor.
- It is treated as the owner of any part of the assets of a foreign trust under the grantor trust rules.
- It received a distribution from a foreign trust.

Note. An owner of a foreign trust must ensure that the trust files an annual information return on Form 3520-A, Annual Information Return of Foreign Trust with a U.S. Owner.

Questions 12a, 12b, and 12c

Note. You must check “Yes” or “No” for each question.

Question 12a. Answer “Yes” if the partnership is making, or has made (and has not revoked) a section 754 election. If the partnership technically terminated under section 708(b)(1)(B), and the new partnership does not make a section 754 election for its first

tax year, the section 754 election is considered “revoked” for purposes of completing question 12a. For information about the election, see item 4 under *Elections Made by the Partnership*.

Question 12b. Answer “Yes” if the partnership made an optional basis adjustment under section 743(b) or 734(b) for the tax year. If the partnership has made a section 754 election (and it has not been revoked) and either of the following transactions occur, the partnership must make a basis adjustment under section 734(b) or 743(b).

Section 743(b) basis adjustment. A section 743(b) basis adjustment is required if there is a transfer of an interest in the partnership by a sale or exchange, or in the death of a partner. See question 12c if the partnership has a substantial built-in loss immediately after such a transfer. The basis adjustment affects only the transferee’s basis in partnership property. The partnership must attach a statement to the return for the tax year in which the transfer occurred. The statement must include:

- The name of the transferee partner,
- The EIN or SSN of the transferee partner,
- The computation of the adjustment, and
- The identity of the partnership properties to which the adjustment has been allocated.

For details, see section 743 and Regulations section 1.743-1. For details on allocating the basis adjustment to partnership properties, see section 755 and Regulations section 1.755-1.

Section 734(b) basis adjustment. A section 734(b) basis adjustment is required if there is a distribution of property to a partner, whether or not in liquidation of the partner’s entire interest in the partnership. See question 12c if there is a substantial built-in loss with respect to the distribution. The basis adjustment affects each partner’s basis in the partnership property. The partnership must attach a statement to the return for the tax year in which the distribution occurred. The statement must include:

- The computation of the adjustment,
- The class of property distributed (ordinary income property or capital gain property), and
- The partnership properties to which the adjustment has been allocated. For details, see section 734 and Regulations section 1.734-1.

For details on allocating the basis adjustment to partnership properties, see section 755 and Regulations section 1.755-1.

Question 12c. Answer “Yes” if the partnership had to make a basis reduction under section 743(b) because of a substantial built-in loss (as defined in section 743(d)) or under section 734(b) because of a substantial basis reduction (as defined in section 734(d)). Section 743(d)(1) provides that, for purposes of section 743, a partnership has a substantial built-in loss with respect to a transfer of a partnership interest if the partnership’s adjusted basis in the partnership’s property exceeds by more than \$250,000 the fair market value of the property. Under section 734(d), there is a substantial basis reduction with respect to a distribution if the sum of the following amounts exceeds \$250,000:

- The amount of loss recognized by the distributee partner on a distribution in liquidation of the partner's interest in the partnership (see section 731(a)(2)), and
- The excess of the basis of the distributed property to the distributee partner (determined under section 732) over the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by section 732(d)).

Section 743(b) basis adjustment. For a section 743(b) basis adjustment, attach a statement that includes:

- Name of the transferee partner,
- EIN or SSN of the transferee partner,
- Computation of the adjustment, and
- Identity of the partnership properties to which the adjustment has been allocated.

Section 734(b) basis adjustment. For a section 734(b) basis adjustment, attach a statement that includes:

- The computation of the adjustment,
- The class of property distributed (ordinary income property or capital gain property), and
- The partnership properties to which the adjustment has been allocated.

Question 13

Check the box if the partnership engaged in a like-kind exchange during the current or immediately preceding tax year and received placement property which it distributed during the current tax year. For purposes of this question, the partnership is considered to have distributed replacement property if the partnership contributed such property to any entity other than a disregarded entity. The distribution of its ownership interest in a disregarded entity is considered a distribution of the underlying property.

Question 14

If a partnership distributed property to its partners to be jointly owned, whether such distribution is direct or through the formation of an intermediate entity, the question must be answered "Yes." For purposes of question 14, an "undivided interest in partnership property" means property that was owned by the partnership either directly or through a disregarded entity and which was distributed to partners as fractional ownership interests. A tenancy in common interest is a type of undivided ownership interest in property which provides each owner the right to transfer property to a third party without destroying the tenancy in common. Partners may agree to partition property held as tenants in common or may seek a court order to partition the property (usually dividing the property into fractional interests in accordance with each partner's ownership interest in the partnership.)

Example. Partnership P is a partnership which files Form 1065. Partnership P holds title to land held for investment. Partnership P converts its title to the land to fractional interests in the name of the partners and distributes such interests to its partners. Partnership P must answer "Yes" to question 14.

Question 15

Enter the number of Form(s) 8858 that are attached to the return. Form 8858 (and its schedules) are used by certain U.S. persons (including domestic partnerships) that own a foreign disregarded entity (FDE) directly, (or, in certain cases, indirectly or constructively) to satisfy the reporting requirements of sections 6011, 6012, 6031, 6038, and the related regulations. See Form 8858 (and its separate instructions) for information on completing the form.

Question 16. Foreign Partners

Answer “Yes” if the partnership had any foreign partners (for purposes of section 1446) at any time during the tax year. Otherwise, answer “No.”

If the partnership had gross income effectively connected with a trade or business in the United States and foreign partners, it may be required to withhold tax under section 1446 on income allocable to foreign partners (without regard to distributions) and file Forms 8804, 8805, and 8813. See Regulations sections 1.1446-1 through 7, for more information.

Designation of Tax Matters Partner (TMP)

If the partnership is subject to the rules for consolidated audit proceedings in sections 6221 through 6234, the partnership can designate a partner as the TMP for the tax year for which the return is filed by completing the *Designation of Tax Matters Partner* section on page 3 of Form 1065. The designated TMP must be a general partner and, in most cases, must also be a U.S. person.

For a limited liability company (LLC), only a member-manager of the LLC is treated as a general partner. A member manager is any owner of an interest in the LLC who, alone or together with others, has the continuing exclusive authority to make the management decisions necessary to conduct the business for which the LLC was formed. If there are no elected or designated member managers, each owner is treated as a member manager.

Schedules K and K-1. Partners’ Distributive Share Items

Purpose of Schedules

Although the partnership is not subject to income tax, the partners are liable for tax on their shares of the partnership income, whether or not distributed, and must include their shares on their tax returns.

Schedule K is a summary schedule of all the partners’ shares of the partnership’s income, credits, deductions, etc. All partnerships must complete Schedule K. Rental activity income (loss) and portfolio income are not reported on page 1 of Form 1065. These amounts are not combined with trade or business activity income (loss). Schedule K is used to report the totals of these and other amounts.

Schedule K-1 (Form 1065) shows each partner's separate share. Attach a copy of each Schedule K-1 to the Form 1065 filed with the IRS; keep a copy with a copy of the partnership return as a part of the partnership's records; and furnish a copy to each partner. If a partnership interest is held by a nominee on behalf of another person, the partnership may be required to furnish Schedule K-1 to the nominee.

How Income Is Shared Among Partners

Allocate shares of income, gain, loss, deduction, or credit among the partners according to the partnership agreement for sharing income or loss generally. Partners may agree to allocate specific items in a ratio different from the ratio for sharing income or loss. For instance, if the net income exclusive of specially allocated items is divided evenly among three partners but some special items are allocated 50% to one, 30% to another, and 20% to the third partner, report the specially allocated items on the appropriate line of the applicable partner's Schedule K-1 and the total on the appropriate line of Schedule K, instead of on the numbered lines on page 1 of Form 1065 or Schedules A or D.

If a partner's interest changed during the year, see section 706(d) before determining each partner's distributive share of any item of income, gain, loss, deduction, etc. Income (loss) is allocated to a partner only for the part of the year in which that person is a member of the partnership. The partnership will either allocate on a daily basis or divide the partnership year into segments and allocate income, loss, or special items in each segment among the persons who were partners during that segment. Partnerships that report their income on the cash basis must allocate interest expense, taxes, and any payment for services or for the use of property on a daily basis if there is any change in any partner's interest during the year.

Special rules on the allocation of income, gain, loss, and deductions generally apply if a partner contributes property to the partnership and the FMV of that property at the time of contribution differs from the contributing partner's adjusted tax basis. Under these rules, the partnership must use a reasonable method of making allocations of income, gain, loss, and deductions from the property so that the contributing partner receives the tax burdens and benefits of any built-in gain or loss (that is, precontribution appreciation or diminution of value of the contributed property).

If the partnership agreement does not provide for the partner's share of income, gain, loss, deduction, or credit, or if the allocation under the agreement does not have substantial economic effect, the partner's share is determined according to the partner's interest in the partnership.

SPECIFIC INSTRUCTIONS (SCHEDULE K-1 ONLY)

General Information

Generally, the partnership is required to prepare and give a Schedule K-1 to each person who was a partner in the partnership at any time during the year. Schedule K-1 must be provided to each partner on or before the day on which the partnership return is required to be filed.

However, if a foreign partnership meets each of the following four requirements, it is not required to file or provide Schedules K-1 for foreign partners (unless the foreign partner

is a pass-through entity through which a U.S. person holds an interest in the foreign partnership).

- The partnership had no gross income effectively connected with the conduct of a trade or business within the United States during its tax year.
- All required Forms 1042 and 1042-S were filed by the partnership or another withholding agent as required by Regulations section 1.1461-1(b) and (c).
- The tax liability for each foreign partner for amounts reportable under Regulations sections 1.1461-1(b) and (c) has been fully satisfied by the withholding of tax at the source.
- The partnership is not a withholding foreign partnership as defined in Regulations section 1.1441-5(c)(2)(i).

Generally, any person who holds an interest in a partnership as a nominee for another person must furnish to the partnership the name, address, etc., of the other person.

If a husband and wife each had an interest in the partnership, prepare a separate Schedule K-1 for each of them.

How to Complete Schedule K-1

If the return is for a fiscal year or a short tax year, fill in the tax year space at the top of each Schedule K-1. On each Schedule K-1, enter the information about the partnership and the partner in Parts I and II (items A through M). In Part III, enter the partner's distributive share of each item of income, deduction, and credit and any other information the partner needs to file the partner's tax return.

Codes. In box 11 and boxes 13 through 20, identify each item by entering a code in the column to the left of the entry space for the dollar amount. These codes are identified in these instructions and on the back of the Schedule K-1.

Attached statements. Enter an asterisk (*) after the code, if any, in the column to the left of the dollar amount entry space for each item for which you have attached a statement providing additional information. For those informational items that cannot be reported as a single dollar amount, enter the code and asterisk in the left-hand column and enter "STMT" in the entry space to the right to indicate that the information is provided on an attached statement. More than one attached statement can be placed on the same sheet of paper and should be identified in alphanumeric order by box number followed by the letter code (if any). For example: "Box 20, Code T – Information Needed to Figure Depletion – Oil and Gas" (followed by the information the partner needs).

PART I. INFORMATION ABOUT THE PARTNERSHIP

On each Schedule K-1, enter the name, address, and identifying number of the partnership.

PART II. INFORMATION ABOUT THE PARTNER

Complete a Schedule K-1 for each partner. On each Schedule K-1, enter the partner's name, address, identifying number, and distributive share items.

Items E and F

For an individual partner, enter the partner's social security number (SSN) or individual taxpayer identification number (ITIN). For all other partners, enter the partner's EIN. However, if a partner is an individual retirement arrangement (IRA), enter the identifying number of the custodian of the IRA. Do not enter the SSN of the person for whom the IRA is maintained.

Foreign partners without a U.S. taxpayer identifying number should be notified by the partnership of the necessity of obtaining a U.S. identifying number. Certain aliens who are not eligible to obtain SSNs can apply for an ITIN on Form W-7, Application for IRS Individual Taxpayer Identification Number.

If a single member limited liability company (LLC) owns an interest in the partnership, and the LLC is treated as a disregarded entity for federal income tax purposes, enter the owner's identifying number in item E and the owner's name and address in item F.

Item G

Complete item G on all Schedules K-1. If a partner holds interests as both a general and limited partner, check both boxes and attach a statement for each activity that shows the amounts allocable to the partner's interest as a limited partner.

Item H. Domestic/Foreign Partner

Check the foreign partner box if the partner is a nonresident alien individual, foreign partnership, foreign corporation, or a foreign estate or trust. Otherwise, check the domestic partner box.

Item I. What Type of Entity Is This Partner?

State on this line whether the partner is an individual, a corporation, an estate, a trust, a partnership, a disregarded entity, an exempt organization, or a nominee (custodian). If the entity is a limited liability company (LLC) and it is treated as other than a disregarded entity for federal income tax purposes, the partnership must enter the LLC's classification for federal income tax purposes (that is, a corporation or partnership). If the partner is a nominee, use one of the following codes after the word "nominee" to indicate the type of entity the nominee represents: I – Individual; C – Corporation; F – Estate or Trust; P – Partnership; DE – Disregarded Entity; E – Exempt Organization; or IRA – Individual Retirement Arrangement.

Item J. Partner's Profit, Loss, and Capital

On each line, enter the partner's share of the partnership's profit, loss, and capital at the beginning and the end of the partnership's tax year as determined under the partnership agreement. If a partner's interest commences after the beginning of the partnership's tax year, enter in the *Beginning* column the percentages that existed for the partner immediately after admission. If a partner's interest terminates before the end of the partnership's tax year, enter in the *Ending* column the percentages that existed immediately before termination.

On the line for *Capital* enter the portion of the capital that the partner would receive if the partnership was liquidated by the distribution of undivided interests in partnership assets and liabilities. If the partner's capital account is negative or zero, express the percentage ownership of capital as zero.

The partner's percentage share of each category must be expressed as a percentage. The percentage must not be negative. The total percentage interest in each category must total 100% for all partners. To determine whether the total beginning and ending percentages are 100%, do not include the beginning percentage for a partner that was not a partner at the beginning of the partnership's tax year or the ending percentage for a partner that left the partnership before the end of the partnership's tax year. If the partnership agreement does not express the partner's share of profit, loss, and capital as fixed percentages, the partnership may use a reasonable method in arriving at each percentage for purposes of completing the items required by item J, as long as such method is consistent with the partnership agreement and is applied consistently from year to year. Maintain records to support the share of profits, share of losses, and share of capital reported for each partner.

Item K. Partner's Share of Liabilities

Enter each partner's share of nonrecourse liabilities, partnership-level qualified nonrecourse financing, and other recourse liabilities at the end of the year.

"Nonrecourse liabilities" are those liabilities of the partnership for which no partner bears the economic risk of loss. The extent to which a partner bears the economic risk of loss is determined under the rules of Regulations section 1.752-2. Do not include partnership-level qualified nonrecourse financing on the line for nonrecourse liabilities.

If the partner terminated his or her interest in the partnership during the year, enter the share that existed immediately before the total disposition. In all other cases, enter it as of the end of the year.

If the partnership is engaged in two or more different types of at-risk activities, or a combination of at-risk activities and any other activity, attach a statement showing the partner's share of nonrecourse liabilities, partnership-level qualified nonrecourse financing, and other recourse liabilities for each activity.

The at-risk rules of section 465 generally apply to any activity carried on by the partnership as a trade or business or for the production of income. These rules generally limit the amount of loss and other deductions a partner can claim from any partnership activity to the amount for which that partner is considered at risk. However, for partners who acquired their partnership interests before 1987, the at-risk rules do not apply to losses from an activity of holding real property the partnership placed in service before 1987. The activity of holding mineral property does not qualify for this exception. Identify on an attachment to Schedule K-1 the amount of any losses that are not subject to the at-risk rules.

If a partnership is engaged in an activity subject to the limitations of section 465(c)(1) (such as, films or videotapes, leasing section 1245 property, farming, or oil and gas property), give each partner his or her share of the total pre-1976 losses from that activity for which there existed a corresponding amount of nonrecourse liability at the

end of each year in which the losses occurred. See Form 6198, At-Risk Limitations, and related instructions for more information.

Qualified nonrecourse financing secured by real property used in an activity of holding real property that is subject to the at-risk rules is treated as an amount at risk. "Qualified nonrecourse financing" generally includes financing for which no one is personally liable for repayment that is borrowed for use in an activity of holding real property and that is loaned or guaranteed by a federal, state, or local government or that is borrowed from a "qualified" person. Qualified persons include any person actively and regularly engaged in the business of lending money, such as a bank or savings and loan association. Qualified persons generally do not include related parties (unless the nonrecourse financing is commercially reasonable and on substantially the same terms as loans involving unrelated persons), the seller of the property, or a person who receives a fee for the partnership's investment in the real property. See section 465(b)(6) for more information on qualified nonrecourse financing.

The partner as well as the partnership must meet the qualified nonrecourse rules. Therefore, the partnership must enter on an attached statement any other information the partner needs to determine if the qualified nonrecourse rules are also met at the partner level.

Item L. Partner's Capital Account Analysis

You are not required to complete item L if the answer to question 6 of Schedule B is "Yes." If you are required to complete this item, see the instructions for Schedule M-2. Check the appropriate box that describes the method of accounting used to compute the partner's capital account.

- Check the "tax basis" box if the method of accounting used to compute the partner's capital account is based on the partnership's income and deductions for federal tax purposes.
- Check the "GAAP" box if it is based on generally accepted accounting principles (GAAP).
- Check the "704(b) book" box if it is based on the capital accounting rules under Regulations section 1.704-1(b)(2)(iv).
- Check the "Other" box if any other method is used to compute the partner's capital account and attach a statement describing the method and showing how the partner's capital account was computed.

SPECIFIC INSTRUCTIONS (SCHEDULES K AND K-1, PART III, EXCEPT AS NOTED)

These instructions refer to the lines on Schedule K and the boxes on Schedule K-1.

Special Allocations

An item is specially allocated if it is allocated to a partner in a ratio different from the ratio for sharing income or loss generally.

Report specially allocated ordinary gain (loss) on Schedule K, line 11, and on Schedule K-1, box 11. Report other specially allocated items in the applicable boxes of the partner's Schedule K-1, with the total amount on the applicable line of Schedule K.

Example. A partnership has a long-term capital gain that is specially allocated to a partner and a net long-term capital gain reported on line 13, of Schedule D that must be reported on line 9a of Schedule K. Because specially allocated gains or losses are not reported on Schedule D, the partnership must report both the net long-term capital gain from Schedule D and the specially allocated gain on line 9a of Schedule K. Box 9a of the Schedule K-1 for the partners must include both the specially allocated gain and the partner's distributive share of the net long-term capital gain from Schedule D.

Income (Loss)

Line 1. Ordinary Business Income (Loss)

Enter the amount from page 1, line 22. Enter the income (loss) without reference to (a) the basis of the partners' interests in the partnership, (b) the partners' at-risk limitations, or (c) the passive activity limitations. These limitations, if applicable, are determined at the partner level.

Line 1 should not include rental activity income (loss) or portfolio income (loss).

Schedule K-1. Enter each partner's distributive share of ordinary business income (loss) in box 1 of Schedule K-1. If the partnership has more than one trade or business activity, identify on an attachment to Schedule K-1 the amount from each separate activity.

Line 2. Net Rental Real Estate Income (Loss)

Enter the net income (loss) from rental real estate activities of the partnership from Form 8825. Attach this form to Form 1065.

Schedule K-1. Enter each partner's distributive share of net rental real estate income (loss) in box 2 of Schedule K-1. If the partnership has more than one rental real estate activity, identify on an attachment to Schedule K-1 the amount attributable to each activity.

Line 3. Other Net Rental Income (Loss)

Enter on line 3a gross income from rental activities other than those reported on Form 8825. Include on line 3a, the gain (loss) from line 17 of Form 4797 that is attributable to the sale, exchange, or involuntary conversion of an asset used in a rental activity other than a rental real estate activity.

Enter on line 3b the deductible expenses of the activity. Attach a statement of these expenses to Form 1065.

Enter on line 3c the net income (loss).

Schedule K-1. Enter each partner's distributive share of net income (loss) from rental activities other than rental real estate activities in box 3 of Schedule K-1. If the partnership has more than one rental activity reported in box 3, identify on an attachment to Schedule K-1 the amount from each activity.

Line 4. Guaranteed Payments to Partners

Guaranteed payments to partners include:

- Payments for salaries, health insurance, and interest deducted by the partnership and reported on Form 1065, page 1, line 10; Form 8825; or on Schedule K, line 3b,
- Compensation deferred under a section 409A nonqualified deferred compensation plan that does not meet the requirements of section 409A reported on line 20c of Schedule K, and
- Payments the partnership must capitalize. See the Instructions for Form 1065, line 10.

Generally, amounts reported on line 4 are not considered to be related to a passive activity. For example, guaranteed payments for personal services paid to a partner would not be passive activity income. Likewise, interest paid to any partner is not passive activity income.

Schedule K-1. Enter each partner's guaranteed payments in box 4 of Schedule K-1.

Portfolio Income

Do not reduce portfolio income by deductions allocated to it. Report such deductions (other than interest expense) on line 13d of Schedule K. Report each partner's distributive share of deductions (other than interest) allocable to portfolio income in box 13 of Schedule K-1, using codes I, K, and L.

Interest expense allocable to portfolio income is generally investment interest expense. It is reported on line 13b of Schedule K. Report each partner's distributive share of interest expense allocable to portfolio income in box 13 of Schedule K-1 using code H.

Line 5. Interest Income

Enter only taxable portfolio interest on this line. Taxable interest is interest from all sources except interest exempt from tax and interest on tax-free covenant bonds. Include interest income from the credit to holders of tax credit bonds.

Schedule K-1. Enter each partner's distributive share of interest income in box 5 of Schedule K-1. If the partnership is reporting interest income from clean renewable energy bonds, or Midwestern tax credit bonds, attach a statement to Schedule K-1 that shows each partner's distributive share of interest income from these credits. Partners need this information to properly adjust the basis of their interest in the partnership under section 54(l)(3)(B).

Line 6a. Ordinary Dividends

Enter only total taxable ordinary dividends on line 6a, including any qualified dividends reported on line 6b.

Schedule K-1. Enter each partner's distributive share of ordinary dividends in box 6a of Schedule K-1.

Line 6b. Qualified Dividends

Enter qualified dividends on line 6b. Except as provided below, qualified dividends are dividends received from domestic corporations and qualified foreign corporations.

Exceptions. The following dividends are not qualified dividends.

- Dividends the partnership received on any share of stock held for less than 61 days during the 121-day period that began 60 days before the ex-dividend date. When determining the number of days the partnership held the stock, it cannot count certain days during which the partnership's risk of loss was diminished. The ex-dividend date is the first date following the declaration of a dividend on which the purchaser of a stock is not entitled to receive the next dividend payment. When counting the number of days the partnership held the stock, include the day the partnership disposed of the stock but not the day the partnership acquired it.
- Dividends attributable to periods totaling more than 366 days that the partnership received on any share of preferred stock held for less than 91 days during the 181-day period that began 90 days before the ex-dividend date. When determining the number of days the partnership held the stock, do not count certain days during which the partnership's risk of loss was diminished. Preferred dividends attributable to periods totaling less than 367 days are subject to the 61-day holding period rule above.
- Dividends that relate to payments that the partnership is obligated to make with respect to short sales or positions in substantially similar or related property.
- Dividends paid by a regulated investment company that are not treated as qualified dividend income under section 854.
- Dividends paid by a real estate investment trust that are not treated as qualified dividend income under section 857(c).

Qualified foreign corporation. A foreign corporation is a qualified foreign corporation if it is:

1. Incorporated in a possession of the United States or
2. Eligible for benefits of a comprehensive income tax treaty with the United States that the Secretary determines is satisfactory for this purpose and that includes an exchange of information program.

If the foreign corporation does not meet either 1 or 2, then it may be treated as a qualified foreign corporation for any dividend paid by the corporation if the stock associated with the dividend paid is readily tradable on an established securities market in the United States.

However, qualified dividends do not include dividends paid by a passive foreign investment company (defined in section 1297) in either the tax year of the distribution or the preceding tax year.

Schedule K-1. Enter each partner's distributive share of qualified dividends in box 6b of Schedule K-1.

Line 7. Royalties

Enter the royalties received by the partnership.

Schedule K-1. Enter each partner's distributive share of royalties in box 7 of Schedule K-1.

Line 8. Net Short-Term Capital Gain (Loss)

Enter the gain (loss) that is portfolio income (loss) from line 6 of Schedule D (Form 1065).

Schedule K-1. Enter each partner's distributive share of net short-term capital gain (loss) in box 8 of Schedule K-1.

Line 9a. Net Long-Term Capital Gain (Loss)

Enter the gain or loss that is portfolio income (loss) from Schedule D (Form 1065), line 13.

Schedule K-1. Enter each partner's distributive share of net long-term capital gain (loss) in box 9a of Schedule K-1.

Caution. *If any gain or loss from lines 6 or 13 of Schedule D is from the disposition of nondepreciable personal property used in a trade or business, it may not be treated as portfolio income. Instead, report it on line 11 of Schedule K and report each partner's distributive share in box 11 of Schedule K-1 using code F.*

Line 9b. Collectibles (28%) Gain (Loss)

Figure the amount attributable to collectibles from the amount reported on Schedule D (Form 1065) line 13. A collectibles gain (loss) is any long-term gain or deductible long-term loss from the sale or exchange of a collectible that is a capital asset.

Collectibles include works of art, rugs, antiques, metal (such as gold, silver, platinum bullion), gems, stamps, coins, alcoholic beverages, and certain other tangible property.

Also, include gain (but not loss) from the sale or exchange of an interest in a partnership or trust held for more than 1 year and attributable to unrealized appreciation of collectibles.

Schedule K-1. Report each partner's distributive share of the collectibles (28%) gain (loss) in box 9b of Schedule K-1.

Line 9c. Unrecaptured Section 1250 Gain

The three types of unrecaptured section 1250 gain must be reported separately on an attached statement to Form 1065.

From the sale or exchange of the partnership's business assets. Figure this amount for each section 1250 property in Part III of Form 4797 (except property for which gain is reported using the installment method on Form 6252) for which you had an entry in Part I of Form 4797 by subtracting line 26g of Form 4797 from the smaller of line 22 or line 24. Figure the total of these amounts for all section 1250 properties. Generally, the result is the partnership's unrecaptured section 1250 gain. However, if the partnership is reporting gain on the installment method for a section 1250 property held more than 1 year, see the next paragraph.

The total unrecaptured section 1250 gain for an installment sale of section 1250 property held more than 1 year is figured in a manner similar to that used in the preceding paragraph. However, the total unrecaptured section 1250 gain must be allocated to the installment payments received from the sale. To do so, the partnership generally must treat the gain allocable to each installment payment as unrecaptured section 1250 gain until all such gain has been used in full. Figure the unrecaptured section 1250 gain for installment payments received during the tax year as the smaller of (a) the amount from line 26 or line 37 of Form 6252 (whichever applies) or (b) the total unrecaptured section 1250 gain for the sale reduced by all gain reported in prior years (excluding section 1250 ordinary income recapture).

From the sale or exchange of an interest in a partnership. Also report as a separate amount any gain from the sale or exchange of an interest in a partnership attributable to unrecaptured section 1250 gain.

From an estate, trust, REIT, or RIC. If the partnership received a Schedule K-1 or Form 1099-DIV from an estate, a trust, a real estate investment trust (REIT), or a regulated investment company (RIC) reporting "unrecaptured section 1250 gain," do not add it to the partnership's own unrecaptured section 1250 gain. Instead, report it as a separate amount. For example, if the partnership received a Form 1099-DIV from a REIT with unrecaptured section 1250 gain, report it as "Unrecaptured section 1250 gain from a REIT."

Schedule K-1. Report each partner's share of unrecaptured section 1250 gain from the sale or exchange of the partnership's business assets in box 9c of Schedule K-1.

If the partnership is reporting unrecaptured section 1250 gain from an estate, trust, REIT, or RIC or from the partnership's sale or exchange of an interest in another partnership, enter "STMT" in box 9c and an asterisk (*) in the left column of the box and attach a statement that separately identifies the amount of unrecaptured section 1250 gain from:

- The sale or exchange of the partnership's business assets.
- The sale or exchange of an interest in another partnership.
- An estate, trust, REIT, or RIC.

Line 10. Net Section 1231 Gain (Loss)

Enter the net section 1231 gain (loss) from Form 4797, line 7, column (g).

Do not include net gain or loss from involuntary conversions due to casualty or theft. Report net gain or loss from involuntary conversions due to casualty or theft on line 11 of Schedule K (box 11, code B, of Schedule K-1). See the instructions for line 11 on how to report net gain (loss) due to a casualty or theft.

Schedule K-1. Report each partner's distributive share of net section 1231 gain (loss) in box 10 of Schedule K-1. If the partnership has more than one rental, trade, or business activity, identify on an attachment to Schedule K-1 the amount of section 1231 gain (loss) from each separate activity.

Line 11. Other Income (Loss)

Enter any other item of income or loss not included on lines 1 through 10. On the line to the left of the entry space for line 11, identify the type of income. If there is more than one type of income, attach a statement to Form 1065 that separately identifies each type and amount of income for each of the following categories. The codes needed for Schedule K-1 reporting are provided for each category.

Other portfolio income (loss) (code A). Portfolio income not reported on lines 5 through 10.

Report and identify other portfolio income or loss on an attachment for line 11.

For example, income reported to the partnership from a real estate mortgage investment conduit (REMIC), in which the partnership is a residual interest holder, would be reported on an attachment for line 11. If the partnership holds a residual interest in a REMIC, report on the attachment for box 11 of Schedule K-1 of the partner's share of the following:

- Taxable income (net loss) from the REMIC (line 1b of Schedules Q (Form 1066)).
- "Excess inclusion" (line 2c of Schedules Q (Form 1066)).
- Section 212 expense (line 3b of Schedules Q (Form 1066)). Do not report these section 212 expense deductions related to portfolio income on Schedules K and K-1.

Because Schedule Q (Form 1066) is a quarterly statement, the partnership must follow the Schedule Q instructions to figure the amounts to report to the partner for the partnership's tax year.

Involuntary conversions (code B). Net gain (loss) from involuntary conversions due to casualty or theft. The amount for this line is shown on Form 4684, Casualties and Thefts, line 41a, 41b, or 42.

Each partner's share must be entered on Schedule K-1. Give each partner a schedule that shows the amounts to be reported on the partner's Form 4684, line 37, columns (b)(i), (b)(ii), and (c).

If there was a gain (loss) from a casualty or theft to property not used in a trade or business or for income-producing purposes, notify the partner. The partnership should not complete Form 4684 for this type of casualty or theft. Instead, each partner will complete his or her own Form 4684.

Section 1256 contracts and straddles (code C). Any net gain or loss from section 1256 contracts from Form 6781, Gains and Losses From Section 1256 Contracts and Straddles.

Mining exploration costs recapture (code D). Provide the information partners will need to recapture certain mining exploration expenditures.

Cancellation of debt (code E). If cancellation of debt is reported to the partnership on Form 1099-C, report each partner's distributive share in box 11 using code E.

Note. Include the amount of income the partnership must recognize for a transfer of a partnership interest in satisfaction of a partnership debt when the debt relieved exceeds the FMV of the partnership interest. See section 108(e)(8) for more information.

Caution. Do not report cancelled debt income deferred under section 108(i) using code E. Instead, report the deferred income using code F. For more information on the section 108(i) election, see Election to defer income from canceled debt, earlier.

Other income (loss) (code F). Include any other type of income, such as:

- The partner's distributive share of the partnership's gain or loss attributable to the sale or exchange of qualified preferred stock of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). On an attached statement, show (a) the gain or loss attributable to the sale or exchange of the qualified preferred stock, (b) the date the stock was acquired by the partnership, and (c) the date the stock was sold or exchanged by the partnership.
- Recoveries of tax benefit items (section 111).
- Gambling gains and losses subject to the limitations in section 165(d). Indicate on an attached statement whether or not the partnership is in the trade or business of gambling.
- Disposition of an interest in oil, gas, geothermal, or other mineral properties. Report the following information on an attached statement to Schedule K-1.
 - (a) Description of the property,
 - (b) The partner's share of the amount realized on the sale, exchange, or involuntary conversion of each property (fair market value of the property for any other disposition, such as a distribution),
 - (c) The partner's share of the partnership's adjusted basis in the property (except for oil or gas properties), and
 - (d) Total intangible drilling costs, development costs, and mining exploration costs (section 59(e) expenditures) passed through to partners for the property. See Regulation section 1.1254-5 for more information.
- Gains from the disposition of farm recapture property (see Form 4797) and other items to which section 1252 applies.
- Any income, gain, or loss to the partnership under section 751(b).
- Specially allocated ordinary gain (loss).
- Any gain or loss from lines 6 or 13 of Schedule D that is not portfolio income (for example gain or loss from the disposition of nondepreciable personal property used in a trade or business).
- Any cancellation of debt income previously deferred as a result of a section 108(i) election that is includible in the current year. See section 108(i) for events that will cause previously deferred income to be reportable, and a special rule for allocating deferred income to the partners. For more information, see *Election to defer income from canceled debt*, earlier.

Special rules for filers of Form 8865. Filers of Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, cannot defer recognizing and reporting canceled debt income on Form 8865, in accordance with the section 108(i) election, unless the foreign partnership filed a U.S. partnership return and made the election. A foreign partnership must file Form 1065 or Form 1065-B to make the section 108(i) election. These foreign partnerships also have an annual reporting requirement on Form 1065 or Form 1065-B for each tax year after the election until all items deferred under section 108(i) have been recognized.

- Gain from the sale or exchange of qualified small business (QSB) stock (as defined in the instructions for Schedule D) that is eligible for the partial section 1202 exclusion. The section 1202 exclusion applies only to qualified small business stock held by the partnership for more than 5 years. Corporate partners are not eligible for the section 1202 exclusion. Additional limitations apply at the partner level. Report each partner's share of section 1202 gain on Schedule K-1. Each partner will determine if he or she qualifies for the section 1202 exclusion. Report on an attachment to Schedule K-1 for each sale or exchange the name of the corporation that issued the QSB stock, the partner's share of the partnership's adjusted basis and sales price of the QSB stock, and the dates the QSB stock was bought and sold.
- Gain eligible for section 1045 rollover (replacement stock purchased by the partnership). Include only gain from the sale or exchange of qualified small business (QSB) stock (as defined in the Instructions for Schedule D) that was deferred by the partnership under section 1045 and reported on Schedule D. See the instructions for Schedule D for more details. The partnership makes the election for section 1045 rollover on a timely filed (including extensions) return for the year in which the sale occurred. Corporate partners are not eligible for the section 1045 rollover. Additional limitations apply at the partner level. Each partner will determine if he or she qualifies for the rollover. Report on an attachment to Schedule K-1 for each sale or exchange (a) the name of the corporation that issued the QSB stock, (b) the partner's share of the partnership's adjusted basis and sales price of the QSB stock, (c) the dates the QSB stock was purchased and sold, (d) the partner's distributive share of gain from the sale of the QSB stock, and (e) the partner's distributive share of the gain that was deferred by the partnership under section 1045. Do not include these amounts on line 11 of Schedule K.
- Gain eligible for section 1045 rollover (replacement stock not purchased by the partnership). Include only gain from the sale or exchange of qualified small business (QSB) stock (as defined in the Instructions for Schedule D) the partnership held for more than 6 months but that was not deferred by the partnership under section 1045. See the instructions for Schedule D for more details. A partner (other than a corporation) may be eligible to defer his or her distributive share of this gain under section 1045 if he or she purchases other QSB stock during the 60-day period that began on the date the QSB stock was sold by the partnership. Additional limitations apply at the partner level. Report on an attachment to Schedule K-1 for each sale or exchange (a) the name of the corporation that issued the QSB stock, (b) the partner's share of the partnership's adjusted basis and sales price of the QSB stock, (c) the dates the QSB stock was bought and sold, and (d) the partner's distributive share of gain from the sale of the QSB stock. For more information see Regulations section 1.1045-1. Do not include these amounts on line 11 of Schedule K.

Schedule K-1. Enter each partner's distributive share of the six other income categories listed above in box 11 of Schedule K-1. Enter the applicable code A, B, C, D, E, or F (as shown above).

If you are reporting each partner's distributive share of only one type of income under code F, enter the code with an asterisk (F*) and the dollar amount in the entry space in box 11 and attach a statement that shows "Box 11, Code F," and the type of income. If you are reporting multiple types of income under code F, enter the code with an asterisk (F*) and enter "STMT" in the entry space in box 11 and attach a statement that shows "Box 11, Code F," and the dollar amount of each type of income.

If the partnership has more than one trade or business or rental activity (for codes B through F), identify on an attachment to Schedule K-1 the amount from each separate activity.

Deductions

Line 12. Section 179 Deduction

A partnership can elect to expense part of the cost of certain property the partnership purchased this year for use in its trade or business or certain rental activities.

Complete Part I of Form 4562 to figure the partnership's section 179 expense deduction. The partnership does not claim the deduction itself but instead passes it through to the partners. Attach Form 4562 to Form 1065 and show the total section 179 expense deduction on Schedule K, line 12.

The partnership must reduce the basis of the asset by the amount of the section 179 expense elected by the partnership, even if a portion of that amount cannot be passed through to its partners that year and must be carried forward because of limitations at the partnership level. Do not reduce the partnership's basis in section 179 property to reflect any portion of the section 179 expense that is allocable to a partner that is a trust or estate.

Identify on an attachment to Schedules K and K-1 the cost of section 179 property placed in service during the year that is qualified enterprise zone, renewal community, qualified section 179 Recovery Assistance, qualified section 179 disaster assistance property, or qualified real property.

See the instructions for line 20c of Schedule K for sales or other dispositions of property for which a section 179 deduction has passed through to partners and for the recapture rules if the business use of the property dropped to 50% or less.

Schedule K-1. Report each partner's distributive share of the section 179 expense deduction in box 12 of Schedule K-1. If the partnership has more than one rental, trade, or business activity, identify on an attachment to Schedule K-1 the amount of section 179 deduction from each separate activity.

Do not complete box 12 of Schedule K-1 for any partner that is an estate or trust; estates and trusts are not eligible for the section 179 expense deduction.

Line 13a. Contributions

Generally, no deduction is allowed for any contribution of \$250 or more unless the partnership obtains a written acknowledgment from the charitable organization that shows the amount of cash contributed, describes any property contributed, and gives an estimate of the value of any goods or services provided in return for the contribution. The acknowledgment must be obtained by the due date (including extensions) of the partnership return or, if earlier, the date the partnership files its return. Do not attach the acknowledgment to the tax return, but keep it with the partnership's records. These rules apply in addition to the filing requirements for Form 8283 described below.

Cash contributions of any amount must be supported by a dated bank record or receipt.

Enter charitable contributions made during the tax year. Attach a statement to Form 1065 that separately identifies the partnership's contributions for each of the following six categories. See *Limits on Deductions* in Publication 526, Charitable Contributions, for information on adjusted gross income (AGI) limitations on deductions for charitable contributions. The codes needed for Schedule K-1 reporting are provided for each category.

Cash contributions (50%) (code A). Enter the amount of cash contributions subject to the 50% AGI limitation.

Cash contributions (30%) (code B). Enter the amount of cash contributions subject to the 30% AGI limitation.

Noncash contributions (50%) (code C). Enter the amount of noncash contributions subject to the 50% AGI limitation. Do not include food inventory contributions reported separately on an attached statement. If property other than cash is contributed and if the claimed deduction for one item or group of similar items of property exceeds \$5,000, the partnership must give each partner a copy of Form 8283, Noncash Charitable Contributions, to attach to the partner's tax return.

Qualified conservation contributions. The AGI limit for qualified conservation contributions under section 170(h) is 50%. The carryover period is 15 years. See section 170(b) and Notice 2007-50, 2007-25 I.R.B. 1430, for details. Report qualified conservation contributions with a 50% AGI limitation on Schedule K-1 in box 13 using code C. Do not include in the amount reported using code C the conservation contributions of property used in agriculture or livestock production reported on Schedule K-1 using code G.

Charitable contributions of food inventory. Attach a statement to Schedule K-1 that shows:

- The deduction for charitable contributions under section 170(e)(3) of qualified inventory that was donated for the care of the ill, needy, and infants. To qualify for the deduction, the food must meet all the quality and labeling standards imposed by federal, state, and local laws and regulations. The amount of the charitable contribution for donated food inventory is the lesser of: (a) the basis of the donated food plus one-half of the appreciation (gain if the donated food was

sold at fair market value on the date of the gift), or (b) twice the amount of basis of the donated food.

- The partner's distributive share of the net income for the tax year from the partnership's trades of businesses that made the contribution of food inventory.

Caution. Do not include the amount of food inventory contributions in the amount reported in box 13 using code C. These contributions must be reported separately on an attached statement because partners must separately determine the limitations on the deduction.

Noncash contributions (30%) (code D). Enter the amount of noncash contributions subject to the 30% AGI limitation.

Capital gain property to a 50% organization (30%) (code E). Enter the amount of capital gain property contributions subject to the 30% AGI limitation.

Capital gain property (20%) (code F). Enter the amount of capital gain property contributions subject to the 20% AGI limitation.

Contributions of property. See *Contributions of Property* in Pub. 526 for information on noncash contributions and contributions of capital gain property. If the deduction claimed for noncash contributions exceeds \$500, complete Form 8283, Noncash Charitable Contributions, and attach it to Form 1065.

If the partnership made a qualified conservation contribution under section 170(h), also include the fair market value of the underlying property before and after the donation, as well as the type of legal interest contributed, and describe the conservation purpose furthered by the donation. Give a copy of this information to each partner.

Nondeductible contributions. Certain contributions made to an organization conducting lobbying activities are not deductible. See section 170(f)(9) for more details. Also, see *Contributions You Cannot Deduct* in Pub. 526 for more examples of nondeductible contributions.

Contributions (100%) (code G). Enter qualified conservation contributions of property used in agriculture or livestock production. The contribution must be subject to a restriction that the property remain available for such production. See section 170(b) for details.

Qualified conservation contributions of property used in agriculture or livestock production. If the partnership is a qualified farmer or rancher (as defined in section 170(b)(1)(E)(v)), show each partner's distributive share of qualified conservation contributions of property used in agriculture or livestock production. Partners will have to separately determine whether they qualify for the 50% or 100% AGI limitation for these contributions. Do not include the amounts reported on the attached statement using code G in the amount reported on Schedule K-1 for qualified conservation contributions using code C.

Schedule K-1. Report each partner's distributive share of charitable contributions in box 13 of Schedule K-1 using codes A through G for each of the contribution categories shown above. The partnership must attach a copy of its Form 8283 to the Schedule K-1 of each partner if the deduction for any item or group of similar items of contributed property exceeds \$5,000, even if the amount allocated to any partner is \$5,000 or less.

Line 13b. Investment Interest Expense

Include on this line the interest properly allocable to debt on property held for investment purposes. Property held for investment includes property that produces income (unless derived in the ordinary course of a trade or business) from interest, dividends, annuities, or royalties; and gains from the disposition of property that produces those types of income or is held for investment.

Investment interest expense does not include interest expense allocable to a passive activity.

Investment income and investment expenses other than interest are reported on lines 20a and 20b respectively. This information is needed by partners to determine the investment interest expense limitation (see Form 4952, Investment Interest Expense Deduction, for details).

Schedule K-1. Report each partner's distributive share of investment interest expense in box 13 of Schedule K-1 using code H.

Lines 13c(1) and 13c(2). Section 59(e)(2) Expenditures

Generally, section 59(e) allows each partner to make an election to deduct the partner's distributive share of the partnership's otherwise deductible qualified expenditures ratably over 10 years (3 years for circulation expenditures), beginning with the tax year in which the expenditures were made (or for intangible drilling and development costs, over the 60-month period beginning with the month in which such costs were paid or incurred).

The term "qualified expenditures" includes only the following types of expenditures paid or incurred during the tax year:

- Circulation expenditures.
- Research and experimental expenditures.
- Intangible drilling and development costs.
- Mining exploration and development costs.

If a partner makes the election, these items are not treated as AMT tax preference items.

Because the partners are generally allowed to make this election, the partnership cannot deduct these amounts or include them as AMT items on Schedule K-1. Instead, the partnership passes through the information the partners need to figure their separate deductions.

On line 13c(1), enter the type of expenditures claimed on line 13c(2). Enter on line 13c(2) the qualified expenditures paid or incurred during the tax year to which an election under section 59(e) may apply. Enter this amount for all partners whether or not any partner makes an election under section 59(e).

On an attached statement, identify the property for which the expenditures were paid or incurred. If the expenditures were for intangible drilling costs or development costs for oil and gas properties, identify the month(s) in which the expenditures were paid or incurred. If there is more than one type of expenditure or more than one property, provide the amounts (and the months paid or incurred if required) for each type of expenditure separately for each property.

Schedule K-1. Report each partner's distributive share of section 59(e) expenditures in box 13 of Schedule K-1 using code J. On an attached statement, identify (a) the type of expenditure, (b) the property for which the expenditures are paid or incurred, and (c) for oil and gas properties only, the month in which intangible drilling costs and development costs were paid or incurred. If there is more than one type of expenditure or the expenditures are for more than one property, provide each partner's distributive share of the amounts (and the months paid or incurred for oil and gas properties) for each type of expenditure separately for each property.

Line 13d. Other Deductions

Enter deductions not included on lines 12, 13a, 13b, 13c(2), and 16l. On the line to the left of the entry space for this line, identify the type of deduction. If there is more than one type of deduction, attach a statement to Form 1065 that separately identifies the type and amount of each deduction for the following nine categories. The codes needed for Schedule K-1 reporting are provided for each category.

Note. Do not include the domestic production activities informational amounts in the total for line 13d.

Deductions – royalty income (code I). Enter the deductions related to royalty income.

Deductions – portfolio (2% floor) (code K). Enter the deductions related to portfolio income that are subject to the 2% of AGI floor (see the instructions for Schedule A (Form 1040)).

Deductions – portfolio (other) (code L). Enter the amount of any other deductions related to portfolio income.

No deduction is allowable under section 212 for expenses allocable to a convention, seminar, or similar meeting. Because these expenses are not deductible by partners, the partnership does not report these expenses on line 13d of Schedule K. The expenses are nondeductible and are reported as such on line 18c of Schedule K and in box 18 of Schedule K-1 using code C.

Schedule K-1. In box 13, report the partner's distributive share of deductions related to portfolio income that are reported on line 13d of Schedule K using codes I (for deductions related to royalty income), K (for deductions related to portfolio income and subject to the 2% of AGI floor), or L (for other deductions related to portfolio income.)

Amounts paid for medical insurance (code M). Enter amounts paid during the tax year for insurance that constitutes medical care for the partner (including the partner's spouse, dependents, and any children under 27 who are not dependents).

Educational assistance benefits (code N). Enter amounts paid during the tax year for educational assistance benefits paid to a partner.

Dependent care benefits (code O). Enter amounts paid during the tax year for dependent care benefits paid on behalf of each partner.

Preproductive period expenses (code P). If the partnership is required to use an accrual method of accounting under section 447 or 448(a)(3), it must capitalize these expenses. If the partnership is permitted to use the cash method, enter the amount of preproductive period expenses that qualify under Regulations section 1.263-4(d). An election not to capitalize these expenses must be made at the partner level.

Commercial revitalization deduction from rental real estate activities (code Q). Enter the commercial revitalization deduction on line 13d only if it is for a rental real estate activity. If the deduction is for a nonrental building, it is deducted by the partnership on line 20 of Form 1065. See the instructions for line 20 for more information.

Pensions and IRAs (code R). Enter the payments for a partner to an IRA, qualified plan, or simplified employee pension (SEP) or SIMPLE IRA plan. If a qualified plan is a defined benefit plan, a partner's distributive share of payments is determined in the same manner as his or her distributive share of partnership taxable income. For a defined benefit plan, attach to the Schedule K-1 for each partner a statement showing the amount of benefit accrued for the tax year.

Reforestation expense deduction (code S). The partnership can elect to deduct a limited amount of its reforestation expenditures paid or incurred during the tax year. Generally, the amount the partnership may elect to deduct is limited to \$10,000 for each qualified timber property. See section 194(c)(3) for a definition of reforestation expenditures and qualified timber property. The partnership must amortize over 84 months any amount not deducted. See the instructions for line 20.

Schedule K-1. Enter the partner's distributive share of the allowable reforestation expenses in box 13 of Schedule K-1 using code S, and attach a statement that provides a description of the qualified timber property. If the partnership is electing to deduct amounts from more than one qualified timber property, provide a description and the amount for each property.

Domestic production activities deduction (codes T, U, and V). The partnership does not compute the domestic production activities deduction, but must provide its partners the information they need to compute the deduction on Form 8903, Domestic Production Activities Deduction. If the partnership meets certain requirements, it can choose to calculate qualified production activities income (QPAI) and Form W-2 wages (W-2 wages) at the partnership level and report these amounts on Schedule K-1 for its qualified partners using codes U and V.

If the partnership does not compute QPAI and W-2 wages at the partnership level or it has partners that are required to compute QPAI at the partner level, it must report on Schedule K-1 using code T the partner's distributive share of the information listed under *QPAI and Form W-2 wages computed at partner level*, below.

QPAI and Form W-2 wages computed at partner level (code T). If the partnership does not calculate QPAI and W-2 wages at the partnership level, attach a statement to Schedule K-1 using code T providing each partner's distributive share of the following information. Do not include these amounts in the total reported on line 13d of Schedule K.

- Domestic production gross receipts (DPGR).
- Gross receipts from all sources.
- Cost of goods sold allocable to DPGR.
- Cost of goods sold from all sources.
- Total deductions, expenses, and losses directly allocable to DPGR.
- Total deductions, expenses, and losses directly allocable to a non-DPGR class of income.
- Other deductions, expenses, and losses not directly allocable to DPGR or another class of income.
- W-2 wages properly allocable to DPGR.
- Any other information a partner needs to use the section 861 method to allocate and apportion cost of goods sold and deductions between DPGR and other receipts. See Form 8903 and its instructions for more details. If the partnership chooses to compute QPAI at the partnership level, see the instructions below.

QPAI and Form W-2 wages computed at partnership level (codes U and V). Eligible partnerships can choose to compute QPAI and W-2 wages at the partnership level and report each qualified partner's distributive share of QPAI (using code U) and W-2 wages (using code V) on Schedule K-1. See the special rules for non-qualifying partners of an eligible section 861 partnership below. Generally, the partnership must allocate QPAI to its partners in the same proportion as gross income and allocate W-2 wages in the same proportion as wage expense. For information on computing QPAI and W-2 wages at the partnership level, see Rev. Proc. 2007-34, 2007-23 I.R.B. 1345, and the Instructions for Form 8903. See the eligibility requirements and reporting rules for each type of eligible partnership below. Qualifying in-kind partnerships and expanded affiliated group partnerships (defined in Temporary Regulations section 1.199-3T(i)(7) and (8)) are not eligible to compute QPAI and W-2 wages at the partnership level.

1. Eligible section 861 partnership. An eligible section 861 partnership is a partnership that satisfies each of the following requirements for its current tax year.

- It has at least 100 partners on any day during the partnership's tax year.
- At least 70% of the partnership is owned, at all times during its tax year, by qualifying partners. A *qualifying partner* is a partner that, on each day during the partnership's tax year that the partner owns an interest in the partnership: (a) is not a general partner or a managing member of a partnership organized as a limited liability company, (b) does not materially participate in the activities of the partnership, (c) does not own, alone or combined with the interests of all related persons, 5% or more of the profits or capital interests in the partnership, or (d) is not an ineligible partnership (qualifying in-kind partnerships and expanded affiliated group partnerships defined in Temporary Regulations section 1.199-3T(i)(7) and (8)).
- It has DPGR.

An eligible section 861 partnership must use the section 861 method of cost allocation to figure QPAI and W-2 wages (see the Instructions for Form 8903 for details). The partnership cannot allocate QPAI and W-2 wages computed at the partnership level to non-qualifying partners (qualifying partners are defined as part of the definition of an eligible section 861 partnership above). Instead, it must attach a statement to the Schedule K-1 for non-qualifying partners that provides the partner's distributive share of the items listed under *QPAI and Form W-2 wages computed at partner level (code T)* earlier. The partnership items allocated to non-qualifying partners must be excluded for purposes of computing QPAI and W-2 wages at the partnership level.

2. Eligible widely-held pass-through partnership. An eligible widely-held pass-through partnership is a partnership that satisfies each of the following requirements for the current tax year.

- It has average annual gross receipts for the 3 tax years preceding the current tax year of \$100 million or less, or has total assets at the end of the current tax year of \$10 million or less.
- It has total cost of goods sold and deductions that, together, are \$100 million or less.
- It has DPGR.
- On every day during the current tax year, all of its partners are individuals, estates, or trusts described (or treated as described) in section 1361(c)(2).
- On every day during the current tax year, no partner owns, alone or combined with the ownership interests of all related persons, more than 10% of the profits or capital interests in the partnership.

An eligible widely-held pass-through partnership must use the simplified deduction method of cost allocation to figure QPAI and W-2 wages (see the Instructions for Form 8903 for details).

3. Eligible small pass-through partnership. An eligible small pass-through partnership is a partnership that satisfies each of the following requirements for the current tax year.

- The partnership satisfies one of the following: (a) It has average annual gross receipts for the 3 tax years preceding the current tax year of \$5 million or less, (b) it is engaged in the trade or business of farming and is not required to use the accrual method of accounting, or (c) it is eligible to use the cash method of accounting under Rev. Proc. 2002-28, 2002-18 I.R.B. 815 (that is, it has average annual gross receipts of \$10 million or less and is not excluded from using the cash method under section 448).
- It has total costs of goods sold and deductions that, together, are \$5 million or less.
- It has DPGR.
- It does not have a partner that is an ineligible partnership (qualifying in-kind partnerships and expanded affiliated group partnerships defined in Temporary Regulations section 1.199-3T(i)(7) and (8)).

An eligible small pass-through partnership must use the small business simplified overall method to figure QPAI and W-2 wages (see the Instructions for Form 8903 for details).

Note. If a partnership satisfies the requirements for more than one type of eligible partnership, it may choose any one of the allocation methods for which it qualified to figure QPAI and W-2 wages. See Rev. Proc. 2007-34 for more information on the eligibility requirements and rules for computing QPAI and W-2 wages at the partnership level.

Other deductions (code W). Include any other deduction, such as:

- Amounts paid by the partnership that would be allowed as itemized deductions on any of the partners' income tax returns if they were paid directly by a partner for the same purpose. These amounts include, but are not limited to, expenses under section 212 for the production of income other than from the partnership's trade or business. However, do not enter expenses related to portfolio income or investment interest expense reported on line 13b of Schedule K on this line.
- Any penalty on early withdrawal of savings not reported on line 13b because the partnership withdrew its time savings deposit before its maturity.
- Soil and water conservation expenditures (section 175).
- Expenditures paid or incurred for the removal of architectural and transportation barriers to the elderly and disabled that the partnership has elected to treat as a current expense.
- Film and television production expenses. The partnership can elect to deduct certain costs of a qualified film or television production if the aggregate cost of the production does not exceed \$15 million. There is a higher dollar limitation for productions in certain areas. Provide a description of the film or television production on an attached statement. If the partnership makes the election for more than one film or television production, attach a statement to Schedule K-1 that shows each partner's distributive share of the qualified expenditures separately for each production. The deduction is subject to recapture under section 1245 if the election is voluntarily revoked or the production fails to meet the requirements for the deduction.
- Interest expense allocated to debt-financed distributions.
- Interest paid or accrued on debt properly allocable to each general partner's share of a working interest in any oil or gas property (if the partner's liability is not limited). General partners that did not materially participate in the oil or gas activity treat this interest as investment interest; for other general partners, it is trade or business interest.
- Contributions to a capital construction fund.
- The partnership's original issue discount (OID) deduction deferred under section 108(i)(2) that is allowable as a deduction in the current year. The aggregate amount of OID that is deferred is generally allowed as a deduction ratably over the five-year period the deferred COD income is includible in income under section 108(i). For more information, see *Election to defer income from cancelled debt*, earlier.

Special rule for filers of Form 8865. Filers of Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, cannot report a section 108(i) OID deduction on Form 8865, in accordance with the section 108(i) election, unless the foreign partnership filed a U.S. partnership return and made the election. A foreign partnership must file Form 1065 or Form 1065-B to make the section 108(i) election. These foreign partnerships also have an annual reporting requirement on Form 1065 or Form 1065-B for each tax year after the election until all items deferred under section 108(i) have been recognized.

Schedule K-1. Enter each partner's distributive share of the nine deduction categories listed above in box 13 of Schedule K-1. Enter the applicable code I, K, L, M, N, O, P, Q, R, S, T, U, V, or W (as shown above).

If you are reporting only one type of deduction under code W, enter code W with an asterisk (W*) and the dollar amount in the entry space in box 13 and attach a statement that shows the box number, code, and type of deduction. If you are reporting multiple types of deductions under code W, enter the code with an asterisk (W*), enter "STMT" in the dollar amount entry space in box 13, and attach a statement that shows the box number, code, and the dollar amount of each type of deduction.

If the partnership has more than one trade or business activity, identify on an attachment to Schedule K-1 the amount for each separate activity.

Self-Employment

General partners. General partners' net earnings (loss) from self-employment do not include:

- Dividends on any shares of stock and interest on any bonds, debentures, notes, etc., unless the dividends or interest are received in the course of a trade or business, such as a dealer in stocks or securities or interest on notes or accounts receivable.
- Rentals from real estate, except rentals of real estate held for sale to customers in the course of a trade or business as a real estate dealer or payments for rooms or space when significant services are provided.
- Royalty income, except royalty income received in the course of a trade or business.

Limited partners. Generally, a limited partner's share of partnership income (loss) is not included in net earnings (loss) from self-employment. Limited partners treat as self-employment earnings only guaranteed payments for services they actually rendered to, or on behalf of, the partnership to the extent that those payments are payment for those services.

Line 14a. Net Earnings (Loss) From Self-Employment

Schedule K. Enter on line 14a the amount from line 5 of the worksheet.

Schedule K-1. Do not complete this line for any partner that is an estate, trust, corporation, exempt organization, or individual retirement arrangement (IRA).

Enter in box 14 of Schedule K-1 each individual general partner's share of the amount shown on line 3c of the worksheet and each individual limited partner's share of the amount shown on line 4c of the worksheet, using code A.

Line 14b. Gross Farming or Fishing Income

Enter on line 14b the partnership's gross farming or fishing income from self-employment. Individual partners need this amount to figure net earnings from self-employment under the farm optional method in Section B, Part II of Schedule SE (Form 1040). Enter each individual partner's distributive share in box 14 of Schedule K-1 using code B.

Line 14c. Gross Nonfarm Income

Enter on line 14c the partnership's gross nonfarm income from self-employment. Individual partners need this amount to figure net earnings from self-employment under the nonfarm optional method in Section B, Part II of Schedule SE (Form 1040). Enter each individual partner's share in box 14 of Schedule K-1 using code C.

Worksheet Instructions

Line 1b. Include on line 1b any part of the net income (loss) from rental real estate activities from Schedule K, line 2, that is from:

1. Rentals of real estate held for sale to customers in the course of a trade or business as a real estate dealer or
2. Rentals for which services were rendered to the occupants (other than services usually or customarily rendered for the rental of space for occupancy only). The supplying of maid service is such a service; but the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, trash collection, etc., are not considered services rendered to the occupants.

Lines 3b and 4b. Allocate the amounts on these lines in the same way Form 1065, page 1, line 22, is allocated to these particular partners.

Line 4a. Include in the amount on line 4a any guaranteed payments to partners reported on Schedule K, line 4, and Schedule K-1, box 4, and derived from a trade or business as defined in section 1402(c). Also include other ordinary business income and expense items (other than expense items subject to separate limitations at the partner level, such as the section 179 expense deduction) reported on Schedules K and K-1 that are used to figure self-employment earnings under section 1402.

Worksheet for Figuring Net Earnings (Loss) From Self-Employment

1a	Ordinary business income (loss) (Schedule K, line 1)	1a		
b	Net income (loss) from certain rental real estate activities (see instructions)	1b		
c	Other net rental income (loss) (Schedule K, line 3c)	1c		
d	Net loss from Form 4797, Part II, line 17, included on line 1a above. Enter as a positive amount	1d		
e	Combine lines 1a through 1d	1e		
2	Net gain from Form 4797, Part II, line 17, included on line 1a above	2		
3a	Subtract line 2 from line 1e. If line 1e is a loss, increase the loss on line 1e by the amount on line 2	3a		
b	Part of line 3a allocated to limited partners, estates, trusts, corporations, exempt organizations, and IRAs	3b		
c	Subtract line 3b from line 3a. If line 3a is a loss, reduce the loss on line 3a by the amount on line 3b. Include each individual general partner's share in box 14 of Schedule K-1, using code A			3c
4a	Guaranteed payments to partners (Schedule K, line 4) derived from a trade or business as defined in section 1402(c) (see instructions)	4a		
b	Part of line 4a allocated to individual limited partners for other than services and to estates, trusts, corporations, exempt organizations, and IRAs	4b		
c	Subtract line 4b from line 4a. Include each individual general partner's share and each individual limited partner's share in box 14 of Schedule K-1, using code A			4c
5	Net earnings (loss) from self-employment. Combine lines 3c and 4c. Enter here and on Schedule K, line 14a			5

Credits

Note. Do not attach Form 3800, General Business Credit, to Form 1065.

Low-Income Housing Credit

Section 42 provides a credit that can be claimed by owners of low-income residential rental buildings. To qualify for this credit, the partnership must file Form 8609, Low-Income Housing Credit Allocation and Certification, separately with the IRS. Do not attach Form 8609 to Form 1065. Complete and attach Form 8586, Low-Income Housing Credit, and Form 8609-A, Annual Statement for Low-Income Housing Credit, to Form 1065.

Line 15a. Low-Income Housing Credit (Section 42(j)(5))

Enter on line 15a the total low-income housing credit for property with respect to which a partnership is to be treated under section 42(j)(5) as the taxpayer to which the low-income housing credit was allowed.

If the partnership invested in another partnership to which the provisions of section 42(j)(5) apply, report on line 15a the credit reported to the partnership on Schedule K-1 (Form 1065), box 15, code A and code C.

Schedule K-1. Report in box 15 of Schedule K-1 each partner's distributive share of the low income housing credit reported on line 15a of Schedule K. Use code A to report credits attributable to buildings placed in service before 2008. Use code C to report credits attributable to buildings placed in service after 2007. If the partnership has credits from more than one rental activity, identify on an attachment to Schedule K-1 the amount for each separate activity.

Line 15b. Low-Income Housing Credit (Other)

Enter on line 15b any low-income housing credit not reported on line 15a. This includes any credit reported to the partnership on Schedule K-1 (Form 1065), box 15, using code B and code D.

Schedule K-1. Report in box 15 of Schedule K-1 each partner's distributive share of the low income housing credit reported on line 15b of Schedule K. Use code B to report credits attributable to buildings placed in service before 2008. Use code D to report credits attributable to buildings placed in service after 2007. If the partnership has credits from more than one rental activity, identify on an attachment to Schedule K-1 the amount for each separate activity.

Line 15c. Qualified Rehabilitation Expenditures (Rental Real Estate)

Enter on line 15c the total qualified rehabilitation expenditures related to rental real estate activities of the partnership. See Form 3468 for details on qualified rehabilitation expenditures.

Schedule K-1. Report each partner's distributive share of qualified rehabilitation expenditures related to rental real estate activities in box 15 of Schedule K-1 using code E. Attach a statement to Schedule K-1 that provides the information and the partner's distributive share of the amounts for lines 11b through 11j and line 11m of Form 3468. See the instructions for Form 3468 for details. If the partnership has expenditures from more than one rental real estate activity, identify on an attachment to Schedule K-1 the amount for each separate activity. See *Passive Activity Reporting Requirements*.

Caution. *Qualified rehabilitation expenditures for property not related to rental real estate activities must be reported in box 20 using code D.*

Line 15d. Other Rental Real Estate Credits

Enter on line 15d any other credit (other than credits reported on lines 15a through 15c) related to rental real estate activities. On the dotted line to the left of the entry space for line 15d, identify the type of credit. If there is more than one type of credit, attach a statement to Form 1065 that identifies the type and amount for each credit. These credits may include any type of credit listed in the instructions for line 15f.

Schedule K-1. Report in box 15 of Schedule K-1 each partner's distributive share of other rental real estate credits using code F. If you are reporting each partner's distributive share of only one type of rental real estate credit under code F, enter the code with an asterisk (F*) and the dollar amount in the entry space in box 15 and attach a statement that shows "Box 15, Code F," and type of credit. If you are reporting multiple types of rental real estate credit under code F, enter the code with an asterisk (F*) and enter a "STMT" in the entry space in box 15 and attach a statement that shows "Box 15, Code F," and the type and dollar amount of the credits. If the partnership has credits from more than one rental real estate activity, identify on the attached statement the amount of each type of credit for each separate activity.

Line 15e. Other Rental Credits

Enter on line 15e any other credit (other than credits reported on lines 15a through 15d) related to rental activities. On the dotted line to the left of the entry space for line 15e, identify the type of credit. If there is more than one type of credit, attach a statement to Form 1065 that identifies the type and amount for each credit. These credits may include any type of credit listed in the instructions for line 15f.

Schedule K-1. Report in box 15 of Schedule K-1 each partner's distributive share of other rental credits using code G. If you are reporting each partner's distributive share of only one type of rental credit under code G, enter the code with an asterisk (G*) and the dollar amount in the entry space in box 15 and attach a statement that shows "Box 15, Code G," and type of credit. If you are reporting multiple types of rental credit under code G, enter the code with an asterisk (G*) and enter "STMT" in the entry space in box 15 and attach a statement that shows "Box 15, Code G," and the type and dollar amount of the credits. If the partnership has credits from more than one rental activity, identify on the attached statement the amount of each type of credit for each separate activity.

Line 15f. Other Credits

Enter on line 15f any other credit, except credits or expenditures shown or listed for lines 15a through 15e. If any of these credits are attributable to rental activities, enter the amount on line 15d or 15e. Do not include any credit recapture amounts on line 15f, but provide credit recapture information on an attached statement of Schedule K-1 as explained below. On the dotted line to the left of the entry space for line 15f, identify the type of credit. If there is more than one type of credit or if there are any credits subject to recapture, attach a statement to Form 1065 that separately identifies each type and amount of credit and credit recapture information for the following categories. The codes needed for box 15 of Schedule K-1 are provided in the heading of each category.

Undistributed capital gains credit (code H). This credit represents taxes paid on undistributed capital gains by a regulated investment company (RIC) or a real estate investment trust (REIT). As a shareholder of a RIC or REIT, the partnership will receive notice of the amount of tax paid on undistributed capital gains on Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains.

Alcohol and cellulosic biofuel fuels credit (code I). Complete Form 6478 to figure the credit. Attach it to Form 1065. Include the amount shown on line 7 of Form 6478 in the partnership's income on line 7 of Form 1065. See section 40(f) for an election the partnership can make to not have the credit apply. If this credit includes the small ethanol producer credit, identify on a statement attached to Schedule K-1 (a) each partner's distributive share of the small ethanol producer credit, (b) the number of gallons of qualified ethanol fuel claimed by the partnership for the small ethanol producer credit, and (c) the partnership's productive capacity for alcohol.

Work opportunity credit (code J). Complete Form 5884 to determine the amount of the credit. Attach it to Form 1065.

Disabled access credit (code K). Complete Form 8826 to determine the amount of the credit. Attach it to Form 1065.

Empowerment zone and renewal community employment credit (code L). Complete Form 8844 to determine the amount of the credit. Attach it to Form 1065.

Credit for increasing research activities (code M). Complete Form 6765 to determine the amount of the credit. Attach it to Form 1065.

Credit for employer social security and Medicare taxes (code N). Complete Form 8846 to determine the amount of the credit. Attach it to Form 1065.

Backup withholding (code O). This credit is for backup withholding on dividends, interest, and other types of income of the partnership.

Other credits (code P). Attach a statement to Form 1065 that identifies the type and amount of any other credits not reported elsewhere, such as:

- New markets credit. Complete Form 8874 to figure the credit. Attach it to Form 1065.
- Nonconventional source fuel credit. Complete Form 8907 to figure the credit and attach it to Form 1065.
- Qualified railroad track maintenance credit. Complete Form 8900 to figure the credit and attach it to Form 1065.
- Unused investment credit from the qualifying advanced coal project credit, qualifying gasification project credit, qualifying advanced energy project credit, or qualifying therapeutic discovery project credit allocated from cooperatives.
- Unused investment credit from the rehabilitation credit or energy credit allocated from cooperatives.
- Renewable electricity, refined coal, and Indian coal production credit. See Rev. Proc. 2007-65 as modified by Announcement 2009-69 and Announcement 2007-112, for a safe harbor method for allocating the credit for wind energy production. Complete Form 8835 to figure the credit. Attach a statement to Form 1065 and Schedule K-1 showing separately the amount of the credit from Part I and from Part II of Form 8835. Attach Form 8835 to Form 1065.
- Indian employment credit. Complete Form 8845 to figure the credit and attach it to Form 1065.
- Orphan drug credit. Complete Form 8820 to figure the credit and attach it to Form 1065.
- Credit for small employer pension plan startup costs. Complete Form 8881 to figure the credit and attach it to Form 1065.
- Credit for employer-provided childcare facilities and services. Complete Form 8882 to figure the credit and attach it to Form 1065.
- Biodiesel and renewable diesel fuels credit. Complete Form 8864 to figure the credit and attach it to Form 1065. Include the amount from line 8 of Form 8864 in the partnership's income on line 7 of Form 1065. If this credit includes the small agri-biodiesel producer credit, identify on a statement attached to Schedule K-1 (a) each partner's distributive share of the small agri-biodiesel producer credit included in the total credit allocated to the partner, (b) the number of gallons for which the partnership claimed the small agri-biodiesel producer credit, and (c) the partnership's productive capacity for agri-biodiesel.
- Low sulfur diesel fuel production credit. Complete Form 8896 to figure the credit and attach it to Form 1065.

- General credits from an electing large partnership.
- Distilled spirits credit (Form 8906).
- Energy efficient home credit (Form 8908).
- Energy efficient appliance credit (Form 8909).
- Alternative motor vehicle credit (Form 8910).
- Alternative fuel vehicle refueling property credit (Form 8911).
- Clean renewable energy bond credit (Form 8912). The amount of this credit (excluding any credits from other partnerships, estates, and trusts) must also be reported as interest income on line 5 of Schedule K.
- Midwestern tax credit bond credit (Form 8912). The amount of this credit (excluding any credits from other partnerships, estates, and trusts) must also be reported as interest income on line 5 of Schedule K.
- New clean renewable energy bond credit (Form 8912). The amount of this credit (excluding any credits from other partnerships, estates, and trusts) must also be reported as interest income on line 5 of Schedule K. In addition, the amount of this credit must also be reported as a cash distribution on line 19a of Schedule K.
- Qualified energy conservation bond credit (Form 8912). The amount of this credit (excluding any credits from other partnerships, estates, and trusts) must also be reported as interest income on line 5 of Schedule K. In addition, the amount of this credit must also be reported as a cash distribution on line 19a of Schedule K.
- Qualified forestry conservation bond credit (Form 8912). The amount of this credit (excluding any credits from other partnerships, estates, and trusts) must also be reported as interest income on line 5 of Schedule K. In addition, the amount of this credit must also be reported as a cash distribution on line 19a of Schedule K.
- Qualified zone academy bond credit (Form 8912). The amount of this credit (excluding any credits from other partnerships, estates, and trusts) must also be reported as interest income on line 5 of Schedule K. In addition, the amount of this credit must also be reported as a cash distribution on line 19a of Schedule K.
- Qualified school construction bond credit (Form 8912). The amount of this credit (excluding any credits from other partnerships, estates, and trusts) must also be reported as interest income on line 5 of Schedule K. In addition, the amount of this credit must also be reported as a cash distribution on line 19a of Schedule K.
- Build America bond credit (Form 8912). The amount of this credit (excluding any credits from other partnerships, estates, and trusts) must also be reported as interest income on line 5 of Schedule K. In addition, the amount of this credit must also be reported as a cash distribution on line 19a of Schedule K.
- Mine rescue team training credit (Form 8923).
- Agricultural chemicals security credit (Form 8931).
- Credit for employer differential wage payments (Form 8932).
- Carbon dioxide sequestration credit (Form 8933).
- Qualified plug-in electric drive motor vehicle credit (Form 8936).

- Qualified plug-in electric vehicle credit (Part I of Form 8834).
- Credit for small employer health insurance premiums (Form 8941).
- New hire retention credit (Form 5884-B).

Schedule K-1. Enter in box 15 of Schedule K-1 each partner's distributive share of the credits listed above. See additional Schedule K-1 reporting information provided in the instructions above. Enter the applicable code H through P in the column to the left of the dollar amount entry space.

If you are reporting each partner's distributive share of only one type of credit under code P, enter the code with an asterisk (P*) and the dollar amount in the entry space in box 15 and attach a statement that shows "Box 15, Code P," and type of credit. If you are reporting multiple types of credit under code P, enter the code with an asterisk (P*) and enter "STMT" in the entry space in box 15 and attach a statement that shows "Box 15, Code P, " and the type and dollar amount of the credits. If the partnership has credits from more than one activity, identify on an attached statement to Schedule K-1 the amount of each type of credit for each separate activity.

Foreign Transactions

Lines 16a through 16n must be completed if the partnership has foreign income, deductions, or losses, or has paid or accrued foreign taxes.

Attach a statement to Schedule K-1 for these coded items providing the information described below. If the partnership had income from, or paid or accrued taxes to, more than one country or U.S. possession, see the requirement for an attached statement in the instruction for line 16a below.

Line 16a. Name of Country or U.S. Possession (Code A)

Enter the name of the foreign country or U.S. possession from which the partnership had income or to which the partnership paid or accrued taxes. If the partnership had income from, or paid or accrued taxes to, more than one foreign country or U.S. possession, enter "See attached" and attach a statement for each country for lines 16a through 16n (codes A through N and code Q of Schedule K-1). On Schedule K-1, if there is more than one country enter code A followed by an asterisk (A*), enter "STMT," and attach a statement to Schedule K-1 for each country for the information and amounts coded A through N and code Q.

Line 16b. Gross Income From all Sources (Code B)

Enter the partnership's gross income from all sources (both U.S. and foreign).

Line 16c. Gross Income Sourced at Partner Level (Code C)

Enter the total gross income of the partnership that is required to be sourced at the partner level. This includes income from the sale of most personal property, other than inventory, depreciable property, and certain intangible property. Attach a statement to Form 1065 showing the following information.

- The amount of this gross income (without regard to its source) in each category identified in the instructions for lines 16d, 16e, and 16f, including each of the listed categories.
- Specifically identify gains on the sale of personal property other than inventory, depreciable property, and certain intangible property on which a foreign tax of 10% or more was paid or accrued. Also list losses on the sale of such property if the foreign country would have imposed a 10% or higher tax had the sale resulted in a gain.
- Specify foreign source capital gains or losses within each separate limitation category. Also separately identify foreign source gains or losses within each separate limitation category that are collectibles (28%) gains and losses or unrecaptured section 1250 gains.

Lines 16d-16f. Foreign Gross Income Sourced at Partnership Level

Separately report gross income from sources outside the United States by category of income as follows.

Line 16d (Code D). Passive foreign source income. This category includes the following income.

- Passive income.
- Dividends from a domestic international sales corporation (DISC) or a former DISC.
- Distributions from a foreign sales corporation (FSC) or a former FSC.

See Line 16f. Other (code F) for exceptions.

Caution: *Passive income does not include export financing interest.*

Line 16e. General category (code E). General category foreign source income. Include all foreign income sourced at the partnership level that is not passive category income. See *Line 16f. Other (code F)* for exceptions.

Line 16f. Other (code F). Attach a statement separately showing the amount of foreign source income included in the following categories:

- Section 901(j) income; and
- Certain income re-sourced by treaty.

Lines 16g-16h. Deductions Allocated and Apportioned at Partner Level

Line 16g. Interest expense (Code G). Enter on line 16g the partnership's total interest expense (including interest equivalents under Temporary Regulations section 1.861-9T(b)). Do not include interest directly allocable under Temporary Regulations section 1.861-10T to income from a specific property. This type of interest is allocated and apportioned at the partnership level and is included on lines 16i through 16k.

Line 16h. Other (Code H). Enter the total of all other deductions or losses that are required to be allocated at the partner level. For example, include on line 16h research and experimental expenditures (see Regulations section 1.861-17(f)).

Lines 16i-16k. Deductions Allocated and Apportioned at Partnership Level to Foreign Source Income

Separately report partnership deductions that are allocated and apportioned at the partnership level by category of income as follows.

Note. Creditable foreign expenditures generally must be allocated in accordance with each partner's interest in the partnership.

Line 16i (Code I). Enter the amount of deductions allocated and apportioned at the partnership level to passive category foreign source income (defined in the instructions for line 16d).

Line 16j. General category (code J). Enter the amount of deductions allocated and apportioned at the partnership level to general category foreign source income (defined in the instructions for line 16e).

Line 16k. Other (code K). Attach a statement separately showing the amount of deductions allocated and apportioned at the partnership level to the following two categories:

- Section 901(j) income; and
- Certain income re-sourced by treaty.

Line 16l. Total Foreign Taxes Paid or Accrued

Enter in U.S. dollars the total foreign taxes (described in section 901 or section 903) that were paid or accrued by the partnership (according to its method of accounting for such taxes). Enter the amount paid on line 16l. Translate these amounts into U.S. dollars by using the applicable exchange rate.

Foreign taxes paid (Code L). If the partnership uses the cash method of accounting, check the Paid box and enter foreign taxes paid during the tax year on line 16l. Report each partner's distributive share in box 16 of Schedule K-1 using code L.

Foreign taxes accrued (Code M). If the partnership uses the accrual method of accounting, check the Accrued box and enter foreign taxes accrued on line 16l. Report each partner's distributive share in box 16 of Schedule K-1 using code M.

A partnership reporting foreign taxes using the cash method can make an irrevocable election to report these taxes using the accrual method for the year of the election and all future years. Make this election by reporting all foreign taxes using the accrual method on line 16l and check the Accrued box (see Regulations section 1.905-1).

Attach a statement reporting the following information.

1. The total amount of foreign taxes (including foreign taxes on income sourced at the partner level) relating to each category of income (see instructions for lines 16d–16f).
2. The dates on which the taxes were paid or accrued, the exchange rates used, and the amounts in both foreign currency and U.S. dollars, for:
 - Taxes withheld at source on interest.
 - Taxes withheld at source on dividends.
 - Taxes withheld at source on rents and royalties.
 - Other foreign taxes paid or accrued.

Line 16m. Reduction in Taxes Available for Credit (Code N)

Enter the total reductions in taxes available for credit. Attach a statement showing the reductions for:

- Taxes on foreign mineral income (section 901(e)).
- Taxes on foreign oil and gas extraction income (section 907(a)).
- Taxes attributable to boycott operations (section 908).
- Failure to timely file (or furnish all of the information required on) Forms 5471 and 8865.
- Any other items (specify).

Line 16n – Other Foreign Tax Information

- **Foreign trading gross receipts (code O).** Report the partner's distributive share of foreign trading gross receipts from line 15 of Form 8873 using code O. See *Extraterritorial Income Exclusion*.
- **Extraterritorial income exclusion (code P).** If the partnership is not permitted to deduct the extraterritorial income exclusion as a non-separately stated item, attach a statement to Schedule K-1 showing the partner's distributive share of the extraterritorial income exclusion reported on line 52 of Form 8873. Also identify the activity to which the exclusion is related.
- **Other foreign transactions (code Q).** Enter in box 16 of Schedule K-1 any other foreign transaction information the partners need to prepare their tax returns using code Q.

Alternative Minimum Tax (AMT) Items

Lines 17a through 17f must be completed for all partners except certain small corporations exempt from the alternative minimum tax (AMT) under section 55(e).

Enter items of income and deductions that are adjustments or tax preference items for the AMT. See Form 6251, Alternative Minimum Tax – Individuals; Form 4626, Alternative Minimum Tax – Corporations; or Schedule I (Form 1041), Alternative Minimum Tax – Estates and Trusts, to determine the amounts to enter and for other information.

Do not include as a tax preference item any qualified expenditures to which an election under section 59(e) may apply. Instead, report these expenditures on line 13c(2). Because these expenditures are subject to an election by each partner, the partnership cannot figure the amount of any tax preference related to them. Instead, the partnership must pass through to each partner in box 13, code J, of Schedule K-1 the information needed to figure the deduction.

Schedule K-1. Report each partner's distributive share of amounts reported on lines 17a through 17f (concerning alternative minimum tax items) in box 17 of Schedule K-1 using codes A through F, respectively. If the partnership is reporting items of income or deduction for oil, gas, and geothermal properties, you may be required to identify these items on a statement attached to Schedule K-1 (see the instructions for *Oil, Gas, and Geothermal Properties – Gross Income and Deductions*, later for details). Also see the requirement for an attached statement in the instructions for line 17f.

Line 17a. Post-1986 Depreciation Adjustment

Figure the adjustment for line 17a based only on tangible property placed in service after 1986 (and tangible property placed in service after July 31, 1986, and before 1987 for which the partnership elected to use the general depreciation system). Do not make an adjustment for motion picture films, videotapes, sound recordings, certain public utility property (as defined in section 168(f)(2), property depreciated under the unit-of-production method (or any other method not expressed in a term of years), qualified Indian reservation property, property eligible for a special depreciation allowance, qualified revitalization expenditures, or the section 179 expense deduction.

For property placed in service before 1999, refigure depreciation for the AMT as follows (using the same convention used for the regular tax).

- For section 1250 property (generally, residential rental and nonresidential real property), use the straight line method over 40 years.
- For tangible property (other than section 1250 property) depreciated using the straight line method for the regular tax, use the straight line method over the property's class life. Use 12 years if the property has no class life.
- For any other tangible property, use the 150% declining balance method, switching to the straight line method the first tax year it gives a larger deduction, over the property's AMT class life. Use 12 years if the property has no class life.

For property placed in service after 1998, refigure depreciation for the AMT only for property depreciated for the regular tax using the 200% declining balance method. For the AMT, use the 150% declining balance method, switching to the straight line method the first tax year it gives a larger deduction, and the same convention and recovery period used for the regular tax.

Figure the adjustment by subtracting the AMT deduction for depreciation from the regular tax deduction and enter the result on line 17a. If the AMT deduction is more than the regular tax deduction, enter the difference as a negative amount. Depreciation capitalized to inventory must also be refigured using the AMT rules. Include on this line the current year adjustment to income, if any, resulting from the difference.

Line 17b. Adjusted Gain (Loss)

If the partnership disposed of any tangible property placed in service after 1986 (or after July 31, 1986, if an election was made to use the General Depreciation System), or if it disposed of a certified pollution control facility placed in service after 1986, refigure the gain or loss from the disposition using the adjusted basis for the AMT. The property's adjusted basis for the AMT is its cost or other basis minus all depreciation or amortization deductions allowed or allowable for the AMT during the current tax year and previous tax years. Enter on this line the difference between the regular tax gain (loss) and the AMT gain (loss). If the AMT gain is less than the regular tax gain, or the AMT loss is more than the regular tax loss, or there is an AMT loss and a regular tax gain, enter the difference as a negative amount.

If any part of the adjustment is allocable to net short-term capital gain (loss), net long-term capital gain (loss), or net section 1231 gain (loss), attach a statement that identifies the amount of the adjustment allocable to each type of gain or loss.

For a net long-term capital gain (loss), also identify the amount of the adjustment that is collectibles (28%) gain (loss).

For a net section 1231 gain (loss), also identify the amount of adjustment that is unrecaptured section 1250 gain.

Line 17c. Depletion (Other Than Oil and Gas)

Do not include any depletion on oil and gas wells. The partners must figure their oil and gas depletion deductions and preference items separately under section 613A.

Refigure the depletion deduction under section 611 for mines, wells (other than oil and gas wells), and other natural deposits for the AMT. Percentage depletion is limited to 50% of the taxable income from the property as figured under section 613(a), using only income and deductions for the AMT. Also, the deduction is limited to the property's adjusted basis at the end of the year as figured for the AMT. Figure this limit separately for each property. When refiguring the property's adjusted basis, take into account any AMT adjustments made this year or in previous years that affect basis (other than the current year's depletion).

Enter the difference between the regular tax and AMT deduction. If the AMT deduction is greater, enter the difference as a negative amount.

Oil, Gas, and Geothermal Properties – Gross Income and Deductions

Generally, the amounts to be entered on lines 17d and 17e are only the income and deductions for oil, gas, and geothermal properties that are used to figure the partnership's ordinary income (loss) (line 22 of Form 1065).

If there are any items of income or deductions for oil, gas, and geothermal properties included in the amounts that are required to be passed through separately to the partners on Schedule K-1 (items not reported on line 1 of Schedule K-1), give each partner a statement that shows, for the box in which the income or deduction is included, the amount of income or deductions included in the total amount for that box. Do not include any of these direct pass-through amounts on line 17d or 17e.

Figure the amounts for lines 17d and 17e separately for oil and gas properties that are not geothermal deposits and for all properties that are geothermal deposits.

Give the partners a statement that shows the separate amounts included in the computation of the amounts on lines 17d and 17e of Schedule K.

Line 17d. Oil, Gas, and Geothermal Properties – Gross Income

Enter the total amount of gross income (within the meaning of section 613(a)) from all oil, gas, and geothermal properties received or accrued during the tax year and included on page 1, Form 1065.

Line 17e. Oil, Gas, and Geothermal Properties – Deductions

Enter the amount of any deductions allowed for the AMT that are allocable to oil, gas, and geothermal properties.

Line 17f. Other AMT Items

Attach a statement to Form 1065 and Schedule K-1 that shows other items not shown on lines 17a through 17e that are adjustments or tax preference items or that the partner needs to complete Form 6251, Form 4626, or Schedule I of Form 1041. See these forms and their instructions to determine the amount to enter.

Other AMT items include the following.

- Accelerated depreciation of real property under pre-1987 rules.
- Accelerated depreciation of leased personal property under pre-1987 rules.
- Long-term contracts entered into after February 28, 1986. Except for certain home construction contracts, the taxable income from these contracts must be figured using the percentage of completion method of accounting for the AMT.
- Losses from tax shelter farm activities. No loss from any tax shelter farm activity is allowed for the AMT.
- Any information needed by certain corporate partners to compute the adjusted current earnings (ACE) adjustment.

Schedule K-1. If you are reporting each partner's distributive share of only one type of AMT item under code F, enter the code with an asterisk (F*) and the dollar amount in the entry space in box 17 and attach a statement that shows the type of AMT item. If you are reporting multiple types of AMT items under code F, enter the code with an asterisk (F*) and enter "STMT" in the entry space in box 17 and attach a statement that shows the dollar amount of each type of AMT item.

Tax-Exempt Income and Nondeductible Expenses

Line 18a. Tax-exempt interest income. Enter on line 18a tax-exempt interest income, including any exempt-interest dividends received from a mutual fund or other regulated investment company.

Line 18b. Other tax-exempt income. Enter on line 18b all income of the partnership exempt from tax other than tax-exempt interest.

Line 18c. Nondeductible expenses. Enter on line 18c nondeductible expenses paid or incurred by the partnership.

Do not include separately stated deductions shown elsewhere on Schedules K and K-1, capital expenditures, or items the deduction for which is deferred to a later tax year.

Schedule K-1. Report in box 18 of Schedule K-1 each partner's distributive share of amounts reported on lines 18a, 18b, and 18c of Schedule K (concerning items affecting partners' basis) using codes A through C, respectively.

Distributions

Line 19a. Distributions of cash and marketable securities. Enter on line 19a the total distributions to each partner of cash and marketable securities that are treated as money under section 731(c)(1). Also include the amount of the credits to holders of tax credit bonds that are treated as cash distributions under section 54A(g) and 54AA(f)(2). The instructions for the separate credits (see *Other Credit (Code P)* under *Line 15f Other Credits*) state when the amount of the credit must be reported as a cash distribution. Do not include distributions of section 737 property (see *Distributions subject to section 737 (code B)*, later). Generally, marketable securities are valued at FMV on the date of distribution. However, the value of marketable securities does not include the distributee partner's share of the gain on the securities distributed to that partner. See section 731(c)(3)(B) for details.

If the amount on line 19a includes marketable securities treated as money, state separately on an attachment to Schedules K and K-1 (a) the partnership's adjusted basis of those securities immediately before the distribution and (b) the FMV of those securities on the date of distribution (excluding the distributee partner's share of the gain on the securities distributed to that partner).

Line 19b. Distributions of other property. Enter on line 19b the total distributions to each partner of property not included on line 19a. In box 19 of Schedule K-1, distributions of section 737 property will be reported separately from other property. The codes used when reporting amounts from line 19b in box 19 of Schedule K-1 appear in the heading for the categories.

Distributions subject to section 737 (code B). If a partner contributed section 704(c) built-in gain property within the last 7 years and the partnership made a distribution of property to that partner other than the previously contributed built-in gain property, attach a statement to the distributee partner's Schedule K-1 that provides the following information.

- The fair market value of the distributed property (other than money).
- The amount of money received in the distribution.
- The net precontribution gain of the partner. This is the net gain (if any) that would have been recognized by the distributee partner under section 704(c)(1)(B) if all the following property had been distributed by the partnership to another partner. This property includes all property contributed by the distributee partner during the 7 years prior to the distribution and that is still held by the partnership at the time of the distribution (see section 737).

Other property (code C). Include all distributions of property not included on line 19a and that are not section 737 property. In computing the amount of the distribution, use the adjusted basis of the property to the partnership immediately before the distribution. In addition, attach a statement showing the adjusted basis and fair market value of each property distributed.

Schedule K-1. Report in box 19 each partner's distributive share of the amount on line 19a using code A. If a statement is attached, enter an asterisk after the code (A*) and "STMT" in the entry space, and attach the required statement. For line 19b, report each partner's distributive share of the amount for other property in box 19 using code B with an asterisk (B*) and "STMT" in the entry space, and attach the required statement. For distributions subject to section 737, enter code C in box 19 with an asterisk (C*) and "STMT" in the entry space, and attach the required statement.

Other Information

Lines 20a and 20b. Investment Income and Expenses

Enter on line 20a the investment income included on lines 5, 6a, 7, and 11, of Schedule K. Do not include other portfolio gains or losses on this line.

Investment income includes gross income from property held for investment, the excess of net gain attributable to the disposition of property held for investment over net capital gain from the disposition of property held for investment, any net capital gain from the disposition of property held for investment that each partner elects to include in investment income under section 163(d)(4)(B)(iii), and any qualified dividend income that the partner elects to include in investment income. Generally, investment income and investment expenses do not include any income or expenses from a passive activity.

Property subject to a net lease is not treated as investment property because it is subject to the passive loss rules. Do not reduce investment income by losses from passive activities.

Enter investment expenses on line 20b. Investment expenses are deductible expenses (other than interest) directly connected with the production of investment income.

Schedule K-1. Report each partner's distributive share of amounts reported on lines 20a and 20b (investment income and expenses) in box 20 of Schedule K-1 using codes A and B, respectively.

If there are other items of investment income or expense included in the amounts that are required to be passed through separately to the partners on Schedule K-1, such as net short-term capital gain or loss, net long-term capital gain or loss, and other portfolio gains or losses, give each partner a statement identifying these amounts.

Line 20c. Other Items and Amounts

Report the following information on a statement attached to Form 1065. On Schedule K-1 enter the appropriate code in box 20 for each information item followed by an asterisk in the left-hand column of the entry space (for example, "C*"). In the right-hand column, enter "STMT." The codes are provided for each information category.

Fuel tax credit information (code C). Report the number of gallons of each fuel sold or used during the tax year for a nontaxable use qualifying for the credit for taxes paid on fuel, type of use, and the applicable credit per gallon.

Qualified rehabilitation expenditures (other than rental real estate) (code D). Enter total qualified rehabilitation expenditures from activities other than rental real estate activities. See Form 3468 for details on qualified rehabilitation expenditures.

Note. Report qualified rehabilitation expenditures related to rental real estate activities on line 15c.

Schedule K-1. Report each partner's distributive share of qualified rehabilitation expenditures related to other than rental real estate activities in box 20 of schedule K-1 using code D. Attach a statement to Schedule K-1 that provides the information and the partner's distributive share of the amounts for lines 11b through 11j and line 11m of Form 3468. See the instructions for Form 3468 for details. If the partnership has expenditures from more than one activity, identify on a statement attached to Schedule K-1 the amount for each separate activity. See *Passive Activity Reporting Requirements*.

Basis of energy property (code E). See the instructions for Form 3468 for details on basis of energy property. In box 20 of Schedule K-1, enter code E followed by an asterisk and enter "STMT" in the entry space for the dollar amount. Attach a statement to Schedule K-1 that provides the information and the partner's distributive share of the amounts the partner will need to figure the amounts to report on lines 12a-d, 12f, 12g, 12i, 12j, 12l, 12m, 12o, and 12q-s of Form 3468. See the instructions for Form 3468 for details.

Recapture of low-income housing credit (codes F and G). If recapture of part or all of the low-income housing credit is required because (a) prior year qualified basis of a building decreased or (b) the partnership disposed of a building or part of its interest in a building, see Form 8611, Recapture of Low-Income Housing Credit. Complete lines 1 through 7 of Part I of Form 8611 to determine the amount of credit to recapture. Use code F on Schedule K-1 to report recapture of the low-income housing credit from a section 42(j)(5) partnership. Use code G to report recapture of any other low-income housing credit. See the instructions for lines 15a and 15b.

Note. If a partner's ownership interest in a building decreased because of a transaction at the partner level, the partnership must provide the necessary information to the partner to figure the recapture.

Caution. *The disposal of a building or an interest therein will generate a credit that the building will continue to be operated as a qualified low-income building for the remainder of the building's compliance period.*

See Form 8586, Form 8611, and section 42 for more information.

Recapture of investment credit (code H). Complete and attach Form 4255, Recapture of Investment Credit, when investment credit property is disposed of, or it no longer qualifies for the credit, before the end of the recapture period or the useful life applicable to the property. State the type of property at the top of Form 4255, and complete lines 2, 4, and 5, whether or not any partner is subject to recapture of the credit.

Attach to each Schedule K-1 a separate statement providing the information the partnership is required to show on Form 4255, but list only the partner's distributive share of the cost of the property subject to recapture. Also indicate the lines of Form 4255 on which the partners should report these amounts.

Recapture of other credits (code I). On an attached statement to Schedule K-1, provide any information partner's will need to report recapture of credits (other than recapture of low-income housing and investment credit reported on Schedule K-1 using codes F, G, and H). Examples of credits subject to the recapture and reported using code I include:

- The qualified plug-in electric vehicle credit. See section 30(e)(5) for details.
- The new markets credit. See Form 8874 for details.
- The Indian employment credit. See section 45A(d) for details
- The credit for employer-provided childcare facilities and services. See section 45F(d).
- The alternative motor vehicle credit. See section 30B(h)(8).
- The alternative fuel vehicle refueling property credit. See section 30C(e)(5).
- The new qualified plug-in electric drive motor vehicles credit. See section 30D(f)(5).

Look-back interest – completed long-term contracts (code J). If the partnership is a closely held (defined in section 460(b)(4)) and it entered into any long-term contracts after February 28, 1986, that are accounted for under either the percentage of completion-capitalized cost method or the percentage of completion method, it must attach a statement to Form 1065 showing the information required in items (a) and (b) of the instructions for lines 1 and 3 of Part II of Form 8697. It must also report the amounts for Part II, lines 1 and 3, to its partners.

Look-back interest – income forecast method (code K). If the partnership closely held (defined in section 460(b)(4)) and it depreciated certain property placed in service after September 13, 1995, under the income forecast method, it must attach to Form 1065 the information specified in the instructions for Form 8866, line 2, for the 3rd and 10th tax years beginning after the tax year the property was placed in service. It must also report the line 2 amounts to its partners.

Dispositions of property with section 179 deductions (code L). This represents gain or loss on the sale, exchange, or other disposition of property for which a section 179 deduction has been passed through to partners. The partnership must provide all the following information with respect to such dispositions (see the instructions for line 6).

- Description of the property.
- Date the property was acquired and placed in service.
- Date of the sale or other disposition of the property.
- The partner's share of the gross sales price or amount realized.
- The partner's share of the cost or other basis plus expense of sale (reduced as explained in the instructions for Form 4797, line 21).
- The partner's share of the depreciation allowed or allowable, determined as described in the instructions for Form 4797, line 22, but excluding the section 179 deduction.
- The partner's share of the section 179 deduction (if any) passed through for the property and the partnership's tax year(s) in which the amount was passed through.
- If the disposition is due to a casualty or theft, a statement indicating so, and any additional information needed by the partner.
- If the sale was an installment sale made during the partnership's tax year, any information the partner needs to complete Form 6252, Installment Sale Income. The partnership also must separately report the partner's share of all payments received for the property in the following tax years. (Installment payments received for sales made in prior tax years should be reported in the same manner used in the prior tax years.)

Recapture of section 179 deduction (code M). This amount represents recapture of section 179 deduction if business use of the property dropped to 50% or less. If the business use of any property (placed in service after 1986) for which a section 179 deduction was passed through to partners dropped to 50% or less (for a reason other than disposition), the partnership must provide all the following information.

- The partner's distributive share of the original basis and depreciation allowed or allowable (not including the section 179 deduction).
- The partner's distributive share of the section 179 deduction (if any) passed through for the property and the partnership's tax year(s) in which the amount was passed through.

Interest expense for corporate partners (code N). Report as an information item each corporate partner's distributive share of the total amount of interest expense reported elsewhere on this return. A corporate partner's distributive share of interest income, interest expense, and partnership liabilities are treated as income, expense, and liabilities of the corporation for purposes of the limitation on the deduction for interest under section 163(j).

Section 453(l)(3) information (code O). Supply any information needed by a partner to compute the interest due under section 453(l)(3). If the partnership elected to report the dispositions of certain timeshares and residential lots on the installment method, each partner's tax liability must be increased by the partner's distributive share of the interest on tax attributable to the installment payments received during the tax year.

Section 453A(c) information (code P). Supply any information needed by a partner to compute the interest due under section 453A(c). If an obligation arising from the disposition of property to which section 453A applies is outstanding at the close of the year, each partner's tax liability must be increased by the tax due under section 453A(c) on the partner's distributive share of the tax deferred under the installment method.

Section 1260(b) information (code Q). Supply any information needed by a partner to figure the interest due under section 1260(b). If the partnership had gain from certain constructive ownership transactions, each partner's tax liability must be increased by the partner's distributive share of interest due on any deferral of gain recognition. See section 1260(b) for details, including how to figure the interest.

Interest allocable to production expenditures (code R). Supply any information needed by a partner to properly capitalize interest as required by section 263A(f).

CCF nonqualified withdrawal (code S). Report nonqualified withdrawals by the partnership from a capital construction fund to partners.

Depletion information – oil and gas (code T). Report gross income and other information relating to oil and gas well properties to partners to allow them to figure the depletion deduction for oil and gas well properties. Allocate to each partner a proportionate share of the adjusted basis of each partnership oil or gas property.

The partnership cannot deduct depletion on oil and gas wells. Each partner must determine the allowable amount to report on his or her return.

Amortization of reforestation costs (code U). Report the amortizable basis of reforestation expenditures paid or incurred before October 23, 2004, for which the partnership elected amortization, and the tax year the amortization began for the current tax year and the 7 preceding tax years. The amortizable basis cannot exceed \$10,000 for each of those tax years.

Unrelated business taxable income (code V). Report any information a partner that is a tax-exempt organization may need to figure its share of unrelated business taxable income under section 512(a)(1) (but excluding any modifications required by paragraphs (8) through (15) of section 512(b)). Partners are required to notify the partnership of their tax-exempt status.

Precontribution gain (loss) (code W). If the partnership distributed any section 704(c) property to any partner **other than** the contributing partner, and the date of the distribution was within 7 years of the date the section 704(c) property was contributed to the partnership, the distribution must be treated as if it were a sale by the contributing partner taking place on the date of the distribution. Section 704(c) property is property that had a fair market value which was either greater or less than the contributing partner's adjusted basis at the time the property was contributed to the partnership. See *Distributions of Contributed Property* for more information. If the partnership made such a distribution during its tax year, attach a statement to the contributing partner's Schedule K-1 that provides the following information.

- The amount of the gain or loss that would have been allocated to the contributing partner if the partnership had sold the section 704(c) property at its fair market value at the time of the distribution. See section 704(c)(1)(B) for details.
- The character of the gain or loss which would have resulted if the partnership had sold the section 704(c) property to the distributee partner.

Enter code *W* in box 20 of Schedule K-1 with an asterisk (*W**) and enter “STMT,” and attach the required statement.

Section 108(i) information (code X). Report the following.

- For the deferred cancellation of debt (COD) income, report the partner’s deferred amount that has not been included in income in the current or prior tax years.
- For the deferred original issue discount (OID) deduction, report the partner’s share of the partnership’s OID deduction deferred under section 108(i)(2)(A)(i) that has not been deducted in the current or prior tax years.
- For the section 752(b) distribution, report the partner’s share of the deferred section 752 amount that is treated as a distribution of money to the partner under section 752 in the current tax year.
- For the deferred section 752(b) distribution, report the partner’s deferred section 752 amount remaining as of the end of the current tax year.

Other information (code Y). Report to each partner:

- Any information a partner that is a publicly traded partnership may need to determine if it meets the 90% qualifying income test of section 7704(c)(2). Partners are required to notify the partnership of their status as a publicly traded partnership.
- If a partner that is a corporation elected under section 168(k)(4) to accelerate the corporation’s pre-2006 AMT and research credits carryforwards in lieu of bonus depreciation, it is required to notify the partnership of this election so the partnership can adjust the electing corporate partner’s distributive share of partnership items that include bonus depreciation. The partnership is required to recompute the partner’s distributive share of the depreciation on any eligible qualified property placed in service by the partnership to eliminate bonus depreciation and use the straight line depreciation method for such property. On an attached statement, list each partnership item that includes bonus depreciation and show the electing corporate partner’s adjustment for each item that results from the recomputed depreciation and elimination of the bonus depreciation. See section 168(k)(4) for more information.
- If the partnership participates in a transaction that must be disclosed on Form 8886, both the partnership and its partners may be required to file Form 8886. The partnership must determine if any of its partners are required to disclose the transaction and provide those partners with information they will need to file Form 8886. This determination is based on the category(s) under which a transaction qualified for disclosures.
- Compensation to partners deferred under a section 409A nonqualified deferred compensation plan that does not meet the requirements of section 409A. Include in this amount any earnings on these deferrals. This amount must also be included on line 4 of Schedule K, Guaranteed Payments to Partners.

- Any income or gain reported on lines 1 through 11 of Schedule K that qualify as inversion gain, if the partnership is an expatriated entity or is a partner in an expatriated entity. Attach a statement to Form 1065 that shows the amount of each type of income or gain included in the inversion gain. The partnership must report each partner's distributive share of the inversion gain in box 20 of Schedule K-1 using code Y. Attach a statement to Schedule K-1 that shows the partner's distributive share of the amount of each type of income or gain included in the inversion gain.
- Qualifying advanced coal project property. Attach a statement to Schedule K-1 showing the partner's distributive share of the amounts that the partner will use when figuring the amounts to report on lines 5a through 5c of the partner's Form 3468. See the Instructions for Form 3468 for details.
- Qualifying gasification project property. Attach a statement to Schedule K-1 showing the partner's distributive share of the amounts that the partner will use when figuring the amounts to report on lines 6a and 6b of the partner's Form 3468. See the Instructions for Form 3468 for details.
- Qualified advanced energy project credit. Attach a statement to Schedule K-1 showing the partner's distributive share of the amounts that the partner will use when figuring the amount to report on line 7 of the partner's Form 3468. See the Instructions for Form 3468 for details.
- Qualifying Therapeutic Discovery Project Credit. Attach a statement to Schedule K-1 showing the partner's distributive share of the amounts that the partner will use when figuring the amount to report on line 8 of the partner's Form 3468. See the instructions for Form 3468 for details.
- The information needed to complete Schedule P (Form 1120-F), *List of Foreign Partner Interests in Partnerships*, on an attached statement for a partner that is: (a) A corporation (identified as a foreign partner under Regulations section 1.1446-1(c)(3)), or (b) A partnership (domestic or foreign) if you know, or have reason to know, that one or more of the partners is a foreign corporation. If the partnership allocates effectively connected income to the partner, provide the information needed to complete lines 1 through 9, 12, 13, 14b, 16a, 16b, and 17 of Schedule P (Form 1120-F). If the partnership does not allocate effectively connected income to the partner, provide the information needed to complete lines 12, 13, and 17 of Schedule P (Form 1120-F). The information must be provided in a format which references the specific line numbers on Schedule P for which the information is provided. For more information, see the Instructions for Schedule P (Form 1120-F).

ANALYSIS OF NET INCOME (LOSS)

For each type of partner shown, enter the portion of the amount shown on line 1 that was allocated to that type of partner. Report all amounts for LLC members on the line for limited partners. The sum of the amounts shown on line 2 must equal the amount shown on line 1. In addition, the amount on line 1 must equal the amount on line 9, Schedule M-1 (if the partnership is required to complete Schedule M-1). If the partnership files Schedule M-3, the amount on line 1 must equal the amount in column (d) of line 26, Part II.

In classifying partners who are individuals as “active” or “passive,” the partnership should apply the rules below. In applying these rules, a partnership should classify each partner to the best of its knowledge and belief. It is assumed that in most cases the level of a particular partner’s participation in an activity will be apparent.

1. If the partnership’s principal activity is a trade or business, classify a general partner as “active” if the partner materially participated in all partnership trade or business activities; otherwise, classify a general partner as “passive.”
2. If the partnership’s principal activity consists of a working interest in an oil or gas well, classify a general partner as “active.”
3. If the partnership’s principal activity is a rental real estate activity, classify a general partner as “active” if the partner actively participated in all of the partnership’s rental real estate activities; otherwise, classify a general partner as “passive.”
4. Classify as “passive” all partners in a partnership whose principal activity is a rental activity other than a rental real estate activity.
5. If the partnership’s principal activity is a portfolio activity, classify all partners as “active.”
6. Classify as “passive” all limited partners and LLC members in a partnership whose principal activity is a trade or business or rental activity.
7. If the partnership cannot make a reasonable determination whether a partner’s participation in a trade or business activity is material or whether a partner’s participation in a rental real estate activity is active, classify the partner as “passive.”

Schedule L. Balance Sheets Per Books

Note. Schedules L, M-1, and M-2 are not required to be completed if the partnership answered “Yes” to question 6 of Schedule B.

The balance sheets should agree with the partnership’s books and records. Attach a statement explaining any differences. There are additional requirements for completing Schedule L for partnerships that are required to file Schedule M-3.

Partnerships reporting to the Interstate Commerce Commission (ICC) or to any national, state, municipal, or other public officer may send copies of their balance sheets prescribed by the ICC or national, state, or municipal authorities, as of the beginning and end of the tax year, instead of completing Schedule L. However, statements filed under this procedure must contain sufficient information to enable the IRS to reconstruct a balance sheet similar to that contained on Form 1065 without contacting the partnership during processing.

All amounts on the balance sheet should be reported in U.S. dollars. If the partnership’s books and records are kept in a foreign currency, the balance sheet should be translated in accordance with U.S. generally accepted accounting principles (GAAP).

Exception. If the partnership or any qualified business unit of the partnership uses the U.S. dollar approximate separate transactions method, Schedule L should reflect the tax balance sheet prepared and translated into U.S. dollars according to Regulations section 1.985-3(d), and not a U.S. GAAP balance sheet.

PARTNERSHIPS REQUIRED TO FILE SCHEDULE M-3

For partnerships required to file Schedule M-3, the amounts reported on Schedule L must be amounts from financial statements used to complete Schedule M-3. If the partnership prepares non-tax-basis financial statements, Schedule M-3 and Schedule L must report non-tax-basis financial statement amounts. If the partnership does not prepare non-tax-basis financial statements, Schedule L must be based on the partnership's books and records and may show tax-basis balance sheet amounts if the partnership books and records reflect only tax-basis amounts.

Line 5. Tax-Exempt Securities

Include on this line:

1. State and local government obligations, the interest on which is excludable from gross income under section 103(a) and
2. Stock in a mutual fund or other regulated investment company that distributed exempt-interest dividends during the tax year of the partnership.

Line 14. Total Assets

Generally, total assets at the beginning of the tax year (Schedule L, line 14, column (b)), must equal total assets at close of the prior tax year (Schedule L, line 14, column (d)). If total assets at the beginning of the year do not equal total assets at the close of the prior tax year, attach a statement explaining the difference.

For purposes of measuring total assets at the end of the year, the partnership's assets may not be netted against or reduced by partnership liabilities. In addition, asset amounts may not be reported as a negative number. If the partnership has an interest in another partnership and uses a tax-basis method for Schedule L, it must show as an asset the adjusted basis of its interest in the other partnership and separately show as a liability its share of the other partnership's liabilities (which are included in the computation of its adjusted basis). See the Partner's Instructions for Schedule K-1 for details on how to figure the adjusted basis of a partnership interest. If Schedule L is non-tax-basis, investment in a partnership may be shown as appropriate under the non-tax-basis accounting method of the partnership including, if required by the non-tax-basis accounting method of the partnership, the equity method of accounting for investments, but must be shown as a non-negative amount.

Example. Partnership A prepares a tax-basis Schedule L and is a general partner in Partnership B, a general partnership. Partnership A's adjusted basis in Partnership B at the end of the tax year is \$16 million. Partnership A's share of Partnership B's liabilities is \$20 million, which is included in the \$16 million adjusted basis amount. On its Schedule L, Partnership A must report \$16 million on line 8 as the amount of its investment asset in Partnership B and report on line 20 its \$20 million share of Partnership B's liabilities. These amounts cannot be netted on Schedule L.

Line 18. All Nonrecourse Loans

Nonrecourse loans are those liabilities of the partnership for which no partner bears the economic risk of loss. If the partnership's nonrecourse liabilities include its share of the liabilities of another partnership, the partnership's share of those liabilities must be reflected on line 18.

Line 20. Other liabilities

A partnership that is a partner in a tiered partnership must include as a liability on line 20 the partner's share of the tiered partnership's liabilities to the extent they are recourse liabilities to the partner.

Schedule M-1. Reconciliation of Income (Loss) Per Books With Income (Loss) Per Return

Line 2

Report on this line income included on Schedule K, lines 1, 2, 3c, 5, 6a, 7, 8, 9a, 10, and 11 not recorded on the partnership's books this year. Describe each such item of income. Attach a statement if necessary.

Line 3. Guaranteed Payments

Include on this line guaranteed payments shown on Schedule K, line 4 (other than amounts paid for insurance that constitutes medical care for a partner, a partner's spouse, a partner's dependents, and any children under age 27 who are not dependents).

Line 4b. Travel and Entertainment

Include on this line:

- Meal and entertainment expenses not deductible under section 274(n).
- Expenses for the use of an entertainment facility.
- The part of business gifts over \$25.
- Expenses of an individual allocable to conventions on cruise ships over \$2,000.
- Employee achievement awards over \$400.
- The part of the cost of entertainment tickets that exceeds face value (also subject to 50% limit).
- The part of the cost of skyboxes that exceeds the face value of nonluxury box seat tickets.
- The part of the cost of luxury water travel expenses not deductible under section 274(m).
- Expenses for travel as a form of education.
- Nondeductible club dues.
- Other nondeductible travel and entertainment expenses.

Schedule M-2. Analysis of Partners' Capital Accounts

Show what caused the changes during the tax year in the partners' capital accounts as reflected on the partnership's books and records. The amounts on Schedule M-2 should equal the total of the amounts reported in item L of all the partners' Schedules K-1.

The partnership may use the tax-basis amounts or apply the rules in Regulations section 1.704-1(b)(2)(iv) to determine the partners' capital accounts in Schedule M-2 and item L of the partners' Schedules K-1. If the beginning and ending capital accounts reported under these rules differ from the amounts reported on Schedule L, attach a statement reconciling any differences.

Line 2. Capital Contributed During Year

Include on line 2a the amount of money contributed and on line 2b the amount of property contributed by each partner to the partnership as reflected on the partnership's books and records.

Line 3. Net Income (Loss) per Books

Enter on line 3 the net income (loss) shown on the partnership books used in maintaining the partner's capital accounts for purposes of Schedule K-1.

Line 6. Distributions

Line 6a. Cash. Enter the amount of money distributed to each partner by the partnership.

Line 6b. Property. Enter the amount of property distributed to each partner by the partnership as reflected on the partnership's books and records. Include withdrawals from inventory for the personal use of a partner.

U.S. Return of Partnership Income

For calendar year 2010, or tax year beginning _____, 2010, ending _____, 20
▶ See separate instructions.

OMB No. 1545-0099

2010

A Principal business activity	Print or type.	Name of partnership	D Employer identification number
B Principal product or service		Number, street, and room or suite no. If a P.O. box, see the instructions.	E Date business started
C Business code number		City or town, state, and ZIP code	F Total assets (see the instructions) \$ _____

- G** Check applicable boxes: (1) Initial return (2) Final return (3) Name change (4) Address change (5) Amended return
(6) Technical termination - also check (1) or (2)
- H** Check accounting method: (1) Cash (2) Accrual (3) Other (specify) ▶ _____
- I** Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶ _____
- J** Check if Schedules C and M-3 are attached

Caution. Include **only** trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.

Income	1a Gross receipts or sales	1a		
	b Less returns and allowances	1b		1c
	2 Cost of goods sold (Schedule A, line 8)			2
	3 Gross profit. Subtract line 2 from line 1c			3
	4 Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)			4
	5 Net farm profit (loss) (attach Schedule F (Form 1040))			5
	6 Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)			6
	7 Other income (loss) (attach statement)			7
	8 Total income (loss). Combine lines 3 through 7			8
Deductions <small>(see the instructions for limitations)</small>	9 Salaries and wages (other than to partners) (less employment credits)			9
	10 Guaranteed payments to partners			10
	11 Repairs and maintenance			11
	12 Bad debts			12
	13 Rent			13
	14 Taxes and licenses			14
	15 Interest			15
	16a Depreciation (if required, attach Form 4562)	16a		
	b Less depreciation reported on Schedule A and elsewhere on return	16b		16c
	17 Depletion (Do not deduct oil and gas depletion.)			17
	18 Retirement plans, etc.			18
19 Employee benefit programs			19	
20 Other deductions (attach statement)			20	
21 Total deductions. Add the amounts shown in the far right column for lines 9 through 20.			21	
22 Ordinary business income (loss). Subtract line 21 from line 8			22	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner or limited liability company member manager) is based on all information of which preparer has any knowledge.

▶ _____ ▶ _____
Signature of general partner or limited liability company member manager Date

May the IRS discuss this return with the preparer shown below (see instructions)? Yes No

Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed	PTIN
	Firm's name ▶			Firm's EIN ▶	
	Firm's address ▶			Phone no.	

Schedule A Cost of Goods Sold (see the instructions)

1	Inventory at beginning of year	1		
2	Purchases less cost of items withdrawn for personal use	2		
3	Cost of labor	3		
4	Additional section 263A costs (attach statement)	4		
5	Other costs (attach statement)	5		
6	Total. Add lines 1 through 5	6		
7	Inventory at end of year	7		
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on page 1, line 2	8		

9a Check all methods used for valuing closing inventory:

(i) Cost as described in Regulations section 1.471-3

(ii) Lower of cost or market as described in Regulations section 1.471-4

(iii) Other (specify method used and attach explanation) ▶

b Check this box if there was a writedown of "subnormal" goods as described in Regulations section 1.471-2(c) . . . ▶

c Check this box if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) . . ▶

d Do the rules of section 263A (for property produced or acquired for resale) apply to the partnership? Yes No

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? . . Yes No
If "Yes," attach explanation.

Schedule B Other Information

1 What type of entity is filing this return? Check the applicable box:

a <input type="checkbox"/> Domestic general partnership	b <input type="checkbox"/> Domestic limited partnership	Yes	No
c <input type="checkbox"/> Domestic limited liability company	d <input type="checkbox"/> Domestic limited liability partnership		
e <input type="checkbox"/> Foreign partnership	f <input type="checkbox"/> Other ▶		

2 At any time during the tax year, was any partner in the partnership a disregarded entity, a partnership (including an entity treated as a partnership), a trust, an S corporation, an estate (other than an estate of a deceased partner), or a nominee or similar person?

3 At the end of the tax year:

a Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital of the partnership? For rules of constructive ownership, see instructions. If "Yes," attach Schedule B-1, Information on Partners Owning 50% or More of the Partnership

b Did any individual or estate own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital of the partnership? For rules of constructive ownership, see instructions. If "Yes," attach Schedule B-1, Information on Partners Owning 50% or More of the Partnership

4 At the end of the tax year, did the partnership:

a Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (iv) below

(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage Owned in Voting Stock

b Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions. If "Yes," complete (i) through (v) below

(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Type of Entity	(iv) Country of Organization	(v) Maximum Percentage Owned in Profit, Loss, or Capital

	Yes	No
5 Did the partnership file Form 8893, Election of Partnership Level Tax Treatment, or an election statement under section 6231(a)(1)(B)(ii) for partnership-level tax treatment, that is in effect for this tax year? See Form 8893 for more details		
6 Does the partnership satisfy all four of the following conditions? a The partnership's total receipts for the tax year were less than \$250,000. b The partnership's total assets at the end of the tax year were less than \$1 million. c Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return. d The partnership is not filing and is not required to file Schedule M-3 If "Yes," the partnership is not required to complete Schedules L, M-1, and M-2; Item F on page 1 of Form 1065; or Item L on Schedule K-1.		
7 Is this partnership a publicly traded partnership as defined in section 469(k)(2)?		
8 During the tax year, did the partnership have any debt that was cancelled, was forgiven, or had the terms modified so as to reduce the principal amount of the debt?		
9 Has this partnership filed, or is it required to file, Form 8918, Material Advisor Disclosure Statement, to provide information on any reportable transaction?		
10 At any time during calendar year 2010, did the partnership have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? See the instructions for exceptions and filing requirements for Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts. If "Yes," enter the name of the foreign country. ►		
11 At any time during the tax year, did the partnership receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the partnership may have to file Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. See instructions		
12a Is the partnership making, or had it previously made (and not revoked), a section 754 election? See instructions for details regarding a section 754 election. b Did the partnership make for this tax year an optional basis adjustment under section 743(b) or 734(b)? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions c Is the partnership required to adjust the basis of partnership assets under section 743(b) or 734(b) because of a substantial built-in loss (as defined under section 743(d)) or substantial basis reduction (as defined under section 734(d))? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions.		
13 Check this box if, during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (other than entities wholly-owned by the partnership throughout the tax year) <input type="checkbox"/>		
14 At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property?		
15 If the partnership is required to file Form 8858, Information Return of U.S. Persons With Respect To Foreign Disregarded Entities, enter the number of Forms 8858 attached. See instructions ►		
16 Does the partnership have any foreign partners? If "Yes," enter the number of Forms 8805, Foreign Partner's Information Statement of Section 1446 Withholding Tax, filed for this partnership. ►		
17 Enter the number of Forms 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, attached to this return. ►		

Designation of Tax Matters Partner (see instructions)

Enter below the general partner designated as the tax matters partner (TMP) for the tax year of this return:

Name of designated TMP	Identifying number of TMP
If the TMP is an entity, name of TMP representative	Phone number of TMP
Address of designated TMP	

Schedule K		Partners' Distributive Share Items	Total amount	
Income (Loss)	1	Ordinary business income (loss) (page 1, line 22)	1	
	2	Net rental real estate income (loss) (attach Form 8825)	2	
	3a	Other gross rental income (loss)	3a	
	b	Expenses from other rental activities (attach statement)	3b	
	c	Other net rental income (loss). Subtract line 3b from line 3a	3c	
	4	Guaranteed payments	4	
	5	Interest income	5	
	6	Dividends: a Ordinary dividends	6a	
		b Qualified dividends	6b	
	7	Royalties	7	
	8	Net short-term capital gain (loss) (attach Schedule D (Form 1065))	8	
9a	Net long-term capital gain (loss) (attach Schedule D (Form 1065))	9a		
b	Collectibles (28%) gain (loss)	9b		
c	Unrecaptured section 1250 gain (attach statement)	9c		
10	Net section 1231 gain (loss) (attach Form 4797)	10		
11	Other income (loss) (see instructions) Type ▶	11		
Deductions	12	Section 179 deduction (attach Form 4562)	12	
	13a	Contributions	13a	
	b	Investment interest expense	13b	
	c	Section 59(e)(2) expenditures: (1) Type ▶ (2) Amount ▶	13c(2)	
d	Other deductions (see instructions) Type ▶	13d		
Self-Employment	14a	Net earnings (loss) from self-employment	14a	
	b	Gross farming or fishing income	14b	
	c	Gross nonfarm income	14c	
Credits	15a	Low-income housing credit (section 42(j)(5))	15a	
	b	Low-income housing credit (other)	15b	
	c	Qualified rehabilitation expenditures (rental real estate) (attach Form 3468)	15c	
	d	Other rental real estate credits (see instructions) Type ▶	15d	
	e	Other rental credits (see instructions) Type ▶	15e	
	f	Other credits (see instructions) Type ▶	15f	
Foreign Transactions	16a	Name of country or U.S. possession ▶		
	b	Gross income from all sources	16b	
	c	Gross income sourced at partner level	16c	
		Foreign gross income sourced at partnership level		
	d	Passive category ▶ e General category ▶ f Other ▶	16f	
		Deductions allocated and apportioned at partner level		
	g	Interest expense ▶ h Other ▶	16h	
		Deductions allocated and apportioned at partnership level to foreign source income		
	i	Passive category ▶ j General category ▶ k Other ▶	16k	
	l	Total foreign taxes (check one): ▶ Paid <input type="checkbox"/> Accrued <input type="checkbox"/>	16l	
m	Reduction in taxes available for credit (attach statement)	16m		
n	Other foreign tax information (attach statement)			
Alternative Minimum Tax (AMT) Items	17a	Post-1986 depreciation adjustment	17a	
	b	Adjusted gain or loss	17b	
	c	Depletion (other than oil and gas)	17c	
	d	Oil, gas, and geothermal properties—gross income	17d	
	e	Oil, gas, and geothermal properties—deductions	17e	
	f	Other AMT items (attach statement)	17f	
Other Information	18a	Tax-exempt interest income	18a	
	b	Other tax-exempt income	18b	
	c	Nondeductible expenses	18c	
	19a	Distributions of cash and marketable securities	19a	
	b	Distributions of other property	19b	
	20a	Investment income	20a	
b	Investment expenses	20b		
c	Other items and amounts (attach statement)			

Analysis of Net Income (Loss)

1	Net income (loss). Combine Schedule K, lines 1 through 11. From the result, subtract the sum of Schedule K, lines 12 through 13d, and 16l						1
2	Analysis by partner type:	(i) Corporate	(ii) Individual (active)	(iii) Individual (passive)	(iv) Partnership	(v) Exempt organization	(vi) Nominee/Other
a	General partners						
b	Limited partners						

Schedule L Balance Sheets per Books		Beginning of tax year		End of tax year	
Assets		(a)	(b)	(c)	(d)
1	Cash				
2a	Trade notes and accounts receivable				
b	Less allowance for bad debts				
3	Inventories				
4	U.S. government obligations				
5	Tax-exempt securities				
6	Other current assets (attach statement)				
7	Mortgage and real estate loans				
8	Other investments (attach statement)				
9a	Buildings and other depreciable assets				
b	Less accumulated depreciation				
10a	Depletable assets				
b	Less accumulated depletion				
11	Land (net of any amortization)				
12a	Intangible assets (amortizable only)				
b	Less accumulated amortization				
13	Other assets (attach statement)				
14	Total assets				
Liabilities and Capital					
15	Accounts payable				
16	Mortgages, notes, bonds payable in less than 1 year				
17	Other current liabilities (attach statement)				
18	All nonrecourse loans				
19	Mortgages, notes, bonds payable in 1 year or more				
20	Other liabilities (attach statement)				
21	Partners' capital accounts				
22	Total liabilities and capital				

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return
 Note. Schedule M-3 may be required instead of Schedule M-1 (see instructions).

1	Net income (loss) per books		6	Income recorded on books this year not included on Schedule K, lines 1 through 11 (itemize):	
2	Income included on Schedule K, lines 1, 2, 3c, 5, 6a, 7, 8, 9a, 10, and 11, not recorded on books this year (itemize):		a	Tax-exempt interest \$	
3	Guaranteed payments (other than health insurance)		7	Deductions included on Schedule K, lines 1 through 13d, and 16l, not charged against book income this year (itemize):	
4	Expenses recorded on books this year not included on Schedule K, lines 1 through 13d, and 16l (itemize):		a	Depreciation \$	
a	Depreciation \$		8	Add lines 6 and 7	
b	Travel and entertainment \$		9	Income (loss) (Analysis of Net Income (Loss), line 1). Subtract line 8 from line 5	
5	Add lines 1 through 4				

Schedule M-2 Analysis of Partners' Capital Accounts

1	Balance at beginning of year		6	Distributions: a Cash	
2	Capital contributed: a Cash		b Property		
	b Property		7	Other decreases (itemize):	
3	Net income (loss) per books				
4	Other increases (itemize):		8	Add lines 6 and 7	
5	Add lines 1 through 4		9	Balance at end of year. Subtract line 8 from line 5	

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

Partner's Share of Income, Deductions, Credits, etc. (For Partner's Use Only)

I. General Instructions

PURPOSE OF SCHEDULE K-1

The partnership uses Schedule K-1 to report your share of the partnership's income, deductions, credits, etc. Keep it for your records. Do not file it with your tax return. The partnership has filed a copy with the IRS.

Although the partnership generally is not subject to income tax, you are liable for tax on your share of the partnership income, whether or not distributed. Include your share on your tax return if a return is required. Use these instructions to help you report the items shown on Schedule K-1 on your tax return.

The amount of loss and deduction that you may claim on your tax return may be less than the amount reported on Schedule K-1. It is the partner's responsibility to consider and apply any applicable limitations.

SALE OR EXCHANGE OF PARTNERSHIP INTEREST

Generally, a partner who sells or exchanges a partnership interest in a section 751(a) exchange must notify the partnership, in writing, within 30 days of the exchange (or, if earlier, by January 15 of the calendar year following the calendar year in which the exchange occurred). A "section 751(a) exchange" is any sale or exchange of a partnership interest in which any money or other property received by the partner in exchange for that partner's interest is attributable to unrealized receivables (as defined in section 751(c)) or inventory items (as defined in section 751(d)).

The written notice to the partnership must include the names and addresses of both parties to the exchange, the identifying numbers of the transferor and (if known) of the transferee, and the exchange date.

An exception to this rule is made for sales or exchanges of publicly traded partnership interests for which a broker is required to file Form 1099-B, Proceeds From Broker and Barter Exchange Transactions.

If a partner is required to notify the partnership of a section 751(a) exchange but fails to do so, a \$50 penalty may be imposed for each such failure for a notification required to be filed before 2011. For notifications required to be filed after 2010, the penalty is \$100 for each such failure. However, no penalty will be imposed if the partner can show that the failure was due to reasonable cause and not willful neglect.

NOMINEE REPORTING

Any person who holds, directly or indirectly, an interest in a partnership as a nominee for another person must furnish a written statement to the partnership by the last day of the month following the end of the partnership's tax year. This statement must include the

name, address, and identifying number of the nominee and such other person, description of the partnership interest held as nominee for that person, and other information required by Temporary Regulations section 1.6031(c)-1T. A nominee that fails to furnish this statement must furnish to the person for whom the nominee holds the partnership interest a copy of Schedule K-1 and related information within 30 days of receiving it from the partnership.

A nominee who fails to furnish when due all the information required by Temporary Regulations section 1.6031(c)-1T, or who furnishes incorrect information, is subject to a \$50 penalty for each statement to be filed before 2011 for which a failure occurs. The maximum penalty is \$100,000 for all such failures during a calendar year. If the nominee intentionally disregards the requirement to report correct information, each \$50 penalty increases to \$100 or, if greater, 10% of the aggregate amount of items required to be reported, and the \$100,000 maximum does not apply. For statements required to be made after 2010, the nominee is subject to a \$100 penalty for each statement for which a failure occurs. The maximum penalty is \$1,500,000 for all such failures during a calendar year. If the nominee intentionally disregards the requirement to report correct information, each \$100 penalty increases to \$250 or, if greater, 10% of the aggregate amount of items required to be reported, and the \$1,500,000 maximum does not apply.

DEFINITIONS

General Partner

A general partner is a partner who is personally liable for partnership debts.

Limited Partner

A limited partner is a partner in a partnership formed under a state limited partnership law, whose personal liability for partnership debts is limited to the amount of money or other property that the partner contributed or is required to contribute to the partnership. Some members of other entities, such as domestic or foreign business trusts or limited liability companies that are classified as partnerships, may be treated as limited partners for certain purposes.

Nonrecourse Loans

Nonrecourse loans are those liabilities of the partnership for which no partner bears the economic risk of loss.

ELECTIONS

Generally, the partnership decides how to figure taxable income from its operations. However, certain elections are made by you separately on your income tax return and not by the partnership. These elections are made under the following code sections:

- Section 59(e) (deduction of certain qualified expenditures ratably over the period of time specified in that section). For more information, see the instructions for code J in box 13.
- Section 108(b)(5) (income from the discharge of indebtedness). This does not include the section 108(i) election.

- Section 263A(d) (preproductive expenses). See the instructions for code P in box 13.
- Section 617 (deduction and recapture of certain mining exploration expenditures).
- Section 901 (foreign tax credit).

LIMITATIONS ON LOSSES, DEDUCTIONS, AND CREDITS

There are separate potential limitations on the amount of partnership losses that you may deduct on your return. These limitations and the order in which you must apply them are as follows: the basis rules, the at-risk limitations, and the passive activity limitations. Each of these limitations is discussed separately below.

Other limitations may apply to specific deductions (for example, the section 179 expense deduction). Generally, specific limitations apply before the basis, at-risk, and passive loss limitations.

Basis Rules

Generally, you may not claim your share of a partnership loss (including a capital loss) to the extent that it is greater than the adjusted basis of your partnership interest at the end of the partnership's tax year. Any losses and deductions not allowed this year because of the basis limit can be carried forward indefinitely and deducted in a later year subject to the basis limit for that year.

The partnership is not responsible for keeping the information needed to figure the basis of your partnership interest. Although the partnership does provide an analysis of the changes to your capital account in item L of Schedule K-1, that information is based on the partnership's books and records and cannot be used to figure your basis.

You can figure the adjusted basis of your partnership interest by adding items that increase your basis and then subtracting items that decrease your basis.

At-Risk Limitations

Generally, if you have (a) a loss or other deduction from any activity carried on as a trade or business or for the production of income by the partnership and (b) amounts in the activity for which you are not at risk, you will have to complete Form 6198, At-Risk Limitations, to figure your allowable loss.

The at-risk rules generally limit the amount of loss and other deductions that you can claim to the amount you could actually lose in the activity. These losses and deductions include a loss on the disposition of assets and the section 179 expense deduction. However, if you acquired your partnership interest before 1987, the at-risk rules do not apply to losses from an activity of holding real property placed in service before 1987 by the partnership. The activity of holding mineral property does not qualify for this exception. The partnership should identify on an attachment to Schedule K-1 the amount of any losses that are not subject to the at-risk limitations.

Generally, you are not at risk for amounts such as the following:

- Nonrecourse loans used to finance the activity, to acquire property used in the activity, or to acquire your interest in the activity, that are not secured by your own property (other than the property used in the activity). See the instructions for item K for the exception for qualified nonrecourse financing secured by real property.
- Cash, property, or borrowed amounts used in the activity (or contributed to the activity, or used to acquire your interest in the activity) that are protected against loss by a guarantee, stop-loss agreement, or other similar arrangement (excluding casualty insurance and insurance against tort liability).
- Amounts borrowed for use in the activity from a person who has an interest in the activity, other than as a creditor, or who is related, under section 465(b)(3), to a person (other than you) having such an interest.

You should get a separate statement of income, expenses, etc., for each activity from the partnership.

Passive Activity Limitations

Section 469 provides rules that limit the deduction of certain losses and credits. These rules apply to partners who:

- Are individuals, estates, trusts, closely held corporations, or personal service corporations and
- Have a passive activity loss or credit for the tax year.

Generally, passive activities include:

1. Trade or business activities in which you did not materially participate and
2. Activities that meet the definition of rental activities under Temporary Regulations section 1.469-1T(e)(3) and Regulations section 1.469-1(e)(3).

Passive activities do not include:

1. Trade or business activities in which you materially participated.
2. Rental real estate activities in which you materially participated if you were a “real estate professional” for the tax year. You were a real estate professional only if you met both of the following conditions:
 - a. More than half of the personal services you performed in trades or businesses were performed in real property trades or businesses in which you materially participated and
 - b. You performed more than 750 hours of services in real property trades or businesses in which you materially participated.

Note. For a closely held C corporation (defined in section 465(a)(1)(B)), the above conditions are treated as met if more than 50% of the corporation’s gross receipts were from real property trades or businesses in which the corporation materially participated.

For purposes of this rule, each interest in rental real estate is a separate activity, unless you elect to treat all interests in rental real estate as one activity. For details on making this election, see the Instructions for Schedule E (Form 1040).

If you are married filing jointly, either you or your spouse must separately meet both of the above conditions, without taking into account services performed by the other spouse.

A real property trade or business is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Services you performed as an employee are not treated as performed in a real property trade or business unless you owned more than 5% of the stock (or more than 5% of the capital or profits interest) in the employer.

3. Working interests in oil or gas wells if you were a general partner.
4. The rental of a dwelling unit any partner used for personal purposes during the year for more than the greater of 14 days or 10% of the number of days that the residence was rented at fair rental value.
5. Activities of trading personal property for the account of owners of interests in the activities.

If you are an individual, an estate, or a trust, and you have a passive activity loss or credit, use Form 8582, *Passive Activity Loss Limitations*, to figure your allowable passive losses and Form 8582-CR, *Passive Activity Credit Limitations*, to figure your allowable passive credits. For a corporation, use Form 8810, *Corporate Passive Activity Loss and Credit Limitations*.

If the partnership had more than one activity, it will attach a statement to your Schedule K-1 that identifies each activity (trade or business activity, rental real estate activity, rental activity other than rental real estate, etc.) and specifies the income (loss), deductions, and credits from each activity.

Material participation. You must determine if you materially participated (a) in each trade or business activity held through the partnership and (b) if you were a real estate professional (defined above), in each rental real estate activity held through the partnership. All determinations of material participation are made based on your participation during the partnership's tax year.

Material participation standards for partners who are individuals are listed below. Special rules apply to certain retired or disabled farmers and to the surviving spouses of farmers.

Corporations should refer to the Instructions for Form 8810 for the material participation standards that apply to them.

Individuals (other than limited partners). If you are an individual (either a general partner or a limited partner who owned a general partnership interest at all times during the tax year), you materially participated in an activity only if one or more of the following apply:

1. You participated in the activity for more than 500 hours during the tax year.
2. Your participation in the activity for the tax year constituted substantially all the participation in the activity of all individuals (including individuals who are not owners of interests in the activity).
3. You participated in the activity for more than 100 hours during the tax year, and your participation in the activity for the tax year was not less than the participation in the activity of any other individual (including individuals who were not owners of interests in the activity) for the tax year.

4. The activity was a significant participation activity for the tax year, and you participated in all significant participation activities (including activities outside the partnership) during the year for more than 500 hours. A significant participation activity is any trade or business activity in which you participated for more than 100 hours during the year and in which you did not materially participate under any of the material participation tests (other than this test).
5. You materially participated in the activity for any 5 tax years (whether or not consecutive) during the 10 tax years that immediately precede the tax year.
6. The activity was a personal service activity and you materially participated in the activity for any 3 tax years (whether or not consecutive) preceding the tax year. A personal service activity involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor.
7. Based on all the facts and circumstances, you participated in the activity on a regular, continuous, and substantial basis during the tax year.

Limited partners. If you are a limited partner, you do not materially participate in an activity unless you meet one of the tests in paragraphs 1, 5, or 6 above.

Work counted toward material participation. Generally, any work that you or your spouse does in connection with an activity held through a partnership (where you own your partnership interest at the time the work is done) is counted toward material participation. However, work in connection with the activity is not counted toward material participation if either of the following applies.

1. The work is not the type of work that owners of the activity would usually do and one of the principal purposes of the work that you or your spouse does is to avoid the passive loss or credit limitations.
2. You do the work in your capacity as an investor and you are not directly involved in the day-to-day operations of the activity. Examples of work done as an investor that would not count toward material participation include:
 - a. Studying and reviewing financial statements or reports on operations of the activity.
 - b. Preparing or compiling summaries or analyses of the finances or operations of the activity for your own use.
 - c. Monitoring the finances or operations of the activity in a nonmanagerial capacity.

Effect of determination. Income (loss), deductions, and credits from an activity are nonpassive if you determine that:

- You materially participated in a trade or business activity of the partnership, or
- You were a real estate professional in a rental real estate activity of the partnership.

If you determine that you did not materially participate in a trade or business activity of the partnership or if you have income (loss), deductions, or credits from a rental activity of the partnership (other than a rental real estate activity in which you materially participated as a real estate professional), the amounts from that activity are passive. Report passive income (losses), deductions, and credits as follows:

1. If you have an overall gain (the excess of income over deductions and losses, including any prior year unallowed loss) from a passive activity, report the income, deductions, and losses from the activity as indicated in these instructions.
2. If you have an overall loss (the excess of deductions and losses, including any prior year unallowed loss, over income) or credits from a passive activity, report the income, deductions, losses, and credits from all passive activities using the Instructions for Form 8582 or Form 8582-CR (or Form 8810), to see if your deductions, losses, and credits are limited under the passive activity rules.

Publicly traded partnerships. The passive activity limitations are applied separately for items (other than the low-income housing credit and the rehabilitation credit) from each publicly traded partnership (PTP). Thus, a net passive loss from a PTP may not be deducted from other passive income. Instead, a passive loss from a PTP is suspended and carried forward to be applied against passive income from the same PTP in later years. If the partner's entire interest in the PTP is completely disposed of, any unused losses are allowed in full in the year of disposition.

If you have an overall gain from a PTP, the net gain is nonpassive income. In addition, the nonpassive income is included in investment income to figure your investment interest expense deduction.

Do not report passive income, gains, or losses from a PTP on Form 8582. Instead, use the following rules to figure and report on the proper form or schedule your income, gains, and losses from passive activities that you held through each PTP you owned during the tax year.

1. Combine any current year income, gains and losses, and any prior year unallowed losses to see if you have an overall gain or loss from the PTP. Include only the same types of income and losses you would include in your net income or loss from a non-PTP passive activity.
2. If you have an overall gain, the net gain portion (total gain minus total losses) is nonpassive income. On the form or schedule you normally use, report the net gain portion as nonpassive income and the remaining income and the total losses as passive income and loss. To the left of the entry space, write "From PTP." It is important to identify the nonpassive income because the nonpassive portion is included in modified adjusted gross income for purposes of figuring on Form 8582 the "special allowance" for active participation in a non-PTP rental real estate activity. In addition, the nonpassive income is included in investment income when figuring your investment interest expense deduction on Form 4952.

Example. If you have Schedule E income of \$8,000, and a Form 4797 prior year unallowed loss of \$3,500 from the passive activities of a particular PTP, you have a \$4,500 overall gain (\$8,000 – \$3,500). On Schedule E, line 28, report the \$4,500 net gain as nonpassive income in column (j). In column (g), report the remaining Schedule E gain of \$3,500 (\$8,000 – \$4,500). On the appropriate line of Form 4797, report the prior year unallowed loss of \$3,500. Be sure to write "From PTP" to the left of each entry space.

3. If you have an overall loss (but did not dispose of your entire interest in the PTP to an unrelated person in a fully taxable transaction during the year), the losses are allowed to the extent of the income, and the excess loss is carried forward to use in a future year when you have income to offset it. Report as a passive loss on the schedule or form you normally use the portion of the loss equal to the income. Report the income as passive income on the form or schedule you normally use.

Example. You have a Schedule E (Form 1040) loss of \$12,000 (current year losses plus prior year unallowed losses) and a Form 4797 gain of \$7,200. Report the \$7,200 gain on the appropriate line of Form 4797. On Schedule E, line 28, report \$7,200 of the losses as a passive loss in column (f). Carry forward to 2011 the unallowed loss of \$4,800 (\$12,000 – \$7,200).

If you have unallowed losses from more than one activity of the PTP or from the same activity of the PTP that must be reported on different forms, you must allocate the unallowed losses on a pro rata basis to figure the amount allowed from each activity or on each form.

Tax tip. To allocate and keep a record of the unallowed losses, use Worksheets 5, 6, and 7 of Form 8582. List each activity of the PTP in Worksheet 5. Enter the overall loss from each activity in column (a). Complete column (b) of Worksheet 5 according to its instructions. Multiply the total unallowed loss from the PTP by each ratio in column (b) and enter the result in column (c) of Worksheet 5. Then, complete Worksheet 6 if all the loss from the same activity is to be reported on one form or schedule. Use Worksheet 7 instead of Worksheet 6 if you have more than one loss to be reported on different forms or schedules for the same activity. Enter the net loss plus any prior year unallowed losses in column (a) of Worksheet 6 (or Worksheet 7 if applicable). The losses in column (c) of Worksheet 6 (column (e) of Worksheet 7) are the allowed losses to report on the forms or schedules. Report both these losses and any income from the PTP on the forms and schedules you normally use.

4. If you have an overall loss and you disposed of your entire interest in the PTP to an unrelated person in a fully taxable transaction during the year, your losses (including prior year unallowed losses) allocable to the activity for the year are not limited by the passive loss rules. A fully taxable transaction is one in which you recognize all your realized gain or loss. Report the income and losses on the forms and schedules you normally use.

Note. For rules on the disposition of an entire interest reported using the installment method, see the Instructions for Form 8582.

Special allowance for a rental real estate activity. If you actively participated in a rental real estate activity, you may be able to deduct up to \$25,000 of the loss from the activity from nonpassive income. This “special allowance” is an exception to the general rule disallowing losses in excess of income from passive activities. The special allowance is not available if you were married, file a separate return for the year, and did not live apart from your spouse at all times during the year.

Only individuals, qualifying estates, and qualifying revocable trusts that made a section 645 election can actively participate in a rental real estate activity. Estates (other than qualifying estates), trusts (other than qualifying revocable trusts that made a section 645 election), and corporations cannot actively participate. Limited partners cannot actively participate unless future regulations provide an exception.

You are not considered to actively participate in a rental real estate activity if at any time during the tax year your interest (including your spouse's interest) in the activity was less than 10% (by value) of all interests in the activity.

Active participation is a less stringent requirement than material participation. You may be treated as actively participating if you participated, for example, in making management decisions or arranging for others to provide services (such as repairs) in a significant and bona fide sense. Management decisions that can count as active participation include approving new tenants, deciding rental terms, approving capital or repair expenditures, and other similar decisions.

An estate is a qualifying estate if the decedent would have satisfied the active participation requirement for the activity for the tax year the decedent died. A qualifying estate is treated as actively participating for tax years ending less than 2 years after the date of the decedent's death.

Modified adjusted gross income limitation. The maximum special allowance that single individuals and married individuals filing a joint return can qualify for is \$25,000. The maximum is \$12,500 for married individuals who file separate returns and who lived apart all times during the year. The maximum special allowance for which an estate can qualify is \$25,000 reduced by the special allowance for which the surviving spouse qualifies.

If your modified adjusted gross income (defined below) is \$100,000 or less (\$50,000 or less if married filing separately), your loss is deductible up to the amount of the maximum special allowance referred to in the preceding paragraph. If your modified adjusted gross income is more than \$100,000 (more than \$50,000 if married filing separately), the special allowance is limited to 50% of the difference between \$150,000 (\$75,000 if married filing separately) and your modified adjusted gross income. When modified adjusted gross income is \$150,000 or more (\$75,000 or more if married filing separately), there is no special allowance.

Modified adjusted gross income is your adjusted gross income figured without taking into account:

- Any passive activity loss.
- Any rental real estate loss allowed under section 469(c)(7) to real estate professionals.
- Any overall loss from a publicly-traded partnership.
- Any taxable social security or equivalent railroad retirement benefits.
- Any deductible contributions to an IRA or certain other qualified retirement plans under section 219.
- The domestic production activities deduction.

- The student loan interest deduction.
- The tuition and fees deduction.
- The deduction for one-half of self-employment taxes.
- The exclusion from income of interest from Series EE or I U.S. Savings Bonds used to pay higher education expenses.
- The exclusion of amounts received under an employer's adoption assistance program.

Commercial revitalization deduction. The special \$25,000 allowance for the commercial revitalization deduction from rental real estate activities is not subject to the active participation rules or modified adjusted gross income limits discussed above. See code Q for box 13.

Special rules for certain other activities. If you have net income (loss), deductions, or credits from any activity to which special rules apply, the partnership will identify the activity and all amounts relating to it on Schedule K-1 or on an attachment.

If you have net income subject to recharacterization under Temporary Regulations section 1.469-2T(f) and Regulations section 1.469-2(f), report such amounts according to the Instructions for Form 8582 (or Form 8810).

If you have net income (loss), deductions, or credits from any of the following activities, treat such amounts as nonpassive and report them as instructed in these instructions:

1. Working interests in oil and gas wells if you are a general partner.
2. The rental of a dwelling unit any partner used for personal purposes during the year for more than the greater of 14 days or 10% of the number of days that the residence was rented at fair rental value.
3. Trading personal property for the account of owners of interests in the activity.

Self-charged interest. The partnership will report any "self-charged" interest income or expense that resulted from loans between you and the partnership (or between the partnership and another partnership or S corporation if both entities have the same owners with the same proportional ownership interest in each entity). If there was more than one activity, the partnership will provide a statement allocating the interest income or expense with respect to each activity. The self-charged interest rules do not apply to your partnership interest if the partnership made an election under Regulations section 1.469-7(g) to avoid the application of these rules.

II. Specific Instructions

PART I. INFORMATION ABOUT THE PARTNERSHIP

Item D

If the box in item D is checked, you are a partner in a publicly traded partnership and must follow the rules discussed under *Publicly traded partnerships*.

PART II. INFORMATION ABOUT THE PARTNER

Item J

Generally, the amounts reported in Item J are based on the partnership agreement. If your interest commenced after the beginning of the partnership's tax year, the partnership will have entered in the *Beginning* column, the percentages that existed for you immediately after admission. If your interest terminated before the end of the partnership's tax year, the partnership will have entered, in the *Ending* column, the percentages that existed immediately before termination.

The ending percentage share shown on the *Capital* line is the portion of the capital you would receive if the partnership was liquidated at the end of its tax year by the distribution of undivided interests in the partnership's assets and liabilities. If your capital account is negative or zero, the partnership will have entered zero on this line.

Item K

Item K should show your share of the partnership's nonrecourse liabilities, partnership-level qualified nonrecourse financing, and other recourse liabilities as of the end of the partnership's tax year. If you terminated your interest in the partnership during the tax year, item K should show the share that existed immediately before the total disposition. A partner's "recourse liability" is any partnership liability for which a partner is personally liable.

Use the total of the three amounts for computing the adjusted basis of your partnership interest.

Generally, you may use only the amounts shown next to "Qualified nonrecourse financing" and "Recourse" to compute your amount at risk. Do not include any amounts that are not at risk if such amounts are included in either of these categories.

If your partnership is engaged in two or more different types of activities subject to the at-risk provisions, or a combination of at-risk activities and any other activity, the partnership should give you a statement showing your share of nonrecourse liabilities, partnership-level qualified nonrecourse financing, and other recourse liabilities for each activity.

Qualified nonrecourse financing secured by real property used in an activity of holding real property that is subject to the at-risk rules is treated as an amount at risk. Qualified nonrecourse financing generally includes financing for which no one is personally liable for repayment that is borrowed for use in an activity of holding real property and that is loaned or guaranteed by a federal, state, or local government or borrowed from a "qualified" person.

Qualified persons include any persons actively and regularly engaged in the business of lending money, such as a bank or savings and loan association. Qualified persons generally do not include related parties (unless the nonrecourse financing is commercially reasonable and on substantially the same terms as loans involving unrelated persons), the seller of the property, or a person who receives a fee for the partnership's investment in the real property.

Both the partnership and you must meet the qualified nonrecourse rules on this debt before you can include the amount shown next to “Qualified nonrecourse financing” in your at-risk computation.

PART III. PARTNER'S SHARE OF CURRENT YEAR INCOME, DEDUCTIONS, CREDITS, AND OTHER ITEMS

The amounts shown in boxes 1 through 20 reflect your share of income, loss, deductions, credits, etc., from partnership business or rental activities without reference to limitations on losses or adjustments that may be required of you because of:

1. The adjusted basis of your partnership interest,
2. The amount for which you are at risk,
3. The passive activity limitations, or
4. Any other limitations that must be taken into account at the shareholder level in figuring taxable income (for example, the section 179 expense limitation).

For information on these provisions, see *Limitations on Losses, Deductions, and Credits*.

If you are an individual and the passive activity rules do not apply to the amounts shown on your Schedule K-1, take the amounts shown and enter them on the lines on your tax return as indicated in the summarized reporting information shown on page 2 of the Schedule K-1. If the passive activity rules do apply, report the amounts shown as indicated in these instructions.

If you are not an individual, report the amounts in each box as instructed on your tax return.

The line numbers in the summarized reporting information on page 2 of Schedule K-1 are references to forms in use for calendar year 2010. If you file your tax return on a calendar year basis, but your partnership files a return for a fiscal year, enter the amounts on your tax return for the year in which the partnership's fiscal year ends. For example, if the partnership's tax year ends in February 2011, report the amounts on your 2011 tax return.

If you have losses, deductions, or credits from a prior year that were not deductible or usable because of certain limitations, such as the basis rules or the at-risk limitations, take them into account in determining your net income, loss, or credits for this year. However, except for passive activity losses and credits, do not combine the prior-year amounts with any amounts shown on this Schedule K-1 to get a net figure to report on any supporting schedules, statements, or forms attached to your return. Instead, report the amounts on the attached schedule, statement, or form on a year-by-year basis.

If the partnership reports a section 743(b) adjustment to partnership items, report these adjustments as separate items on Form 1040 in accordance with the reporting instructions for the partnership item being adjusted. A section 743(b) adjustment increases or decreases your distributive share of income, deduction, gain, or loss for a partnership item. For example, if the partnership reports a section 743(b) adjustment to depreciation for property used in its trade or business, report the adjustment on line 28 of Schedule E (Form 1040) in accordance with the instructions for box 1 of Schedule K-1.

Caution. If you have amounts other than those shown on Schedule K-1 to report on Schedule E (Form 1040), enter each item separately on line 28 of Schedule E (Form 1040).

Codes. In box 11 and boxes 13 through 20, the partnership will identify each item by entering a code in the column to the left of the dollar amount entry space. These codes are identified on page 2 of Schedule K-1 and in these instructions.

Attached Statements. The partnership will enter an asterisk (*) after the code, if any, in the column to the left of the dollar amount entry space for each item for which it has attached a statement providing additional information. For those informational items that cannot be reported as a single dollar amount, the partnership will enter an asterisk in the left column and write "STMT" in the dollar amount entry space to indicate the information is provided on an attached statement.

INCOME (LOSS)

Box 1. Ordinary Business Income (Loss)

The amount reported for box 1 is your share of the ordinary income (loss) from the trade or business activities of the partnership. Generally, where you report this amount on Form 1040 depends on whether the amount is from an activity that is a passive activity to you. If you are an individual partner filing your 2010 Form 1040, find your situation below and report your box 1 income (loss) as instructed, after applying the basis and at-risk limitations on losses. If the partnership had more than one trade or business activity, it will attach a statement that will identify the amount of income or loss from each activity.

1. Report box 1 income (loss) from partnership trade or business activities in which you materially participated on Schedule E (Form 1040), line 28, column (h) or (j).
2. Report box 1 income (loss) from partnership trade or business activities in which you did not materially participate, as follows:
 - a. If income is reported in box 1, report the income on Schedule E, line 28, column (g). However, if the box in item D is checked, report the income following the rules for *Publicly traded partnerships*.
 - b. If a loss is reported in box 1, follow the Instructions for Form 8582 to figure how much of the loss can be reported on Schedule E, line 28, column (f). However, if the box in item D is checked, report the loss following the rules for *Publicly traded partnerships*.

Box 2. Net Rental Real Estate Income (Loss)

Generally, the income (loss) reported in box 2 is a passive activity amount for all partners. However, the income (loss) in box 2 is not from a passive activity if you were a real estate professional and you materially participated in the activity. If the partnership had more than one real estate rental activity, it will attach a statement that will identify the amount of income or loss from each activity.

If you are filing a 2010 Form 1040, use the following instructions to determine where to enter a box 2 amount:

1. If you have a loss from a passive activity in box 2 and you meet all of the following conditions, enter the loss on Schedule E (Form 1040), line 28, column (f).
 - a. You actively participated in the partnership rental real estate activities. See *Special allowance for a rental real estate activity*.
 - b. Rental real estate activities with active participation were your only passive activities.
 - c. You have no prior year unallowed losses from these activities.
 - d. Your total loss from the rental real estate activities was not more than \$25,000 (not more than \$12,500 if married filing separately and you lived apart from your spouse all year).
 - e. If you are a married person filing separately, you lived apart from your spouse all year.
 - f. You have no current or prior year unallowed credits from a passive activity.
 - g. Your modified adjusted gross income was not more than \$100,000 (not more than \$50,000 if married filing separately and you lived apart from your spouse all year).
 - h. Your interest in the rental real estate activity was not held as a limited partner.
2. If you have a loss from a passive activity in box 2 and you do not meet all the conditions in 1 above, report the loss following the Instructions for Form 8582 to figure how much of the loss you can report on Schedule E (Form 1040), line 28, column (f). However, if the box in item D is checked, report the loss following the rules for *Publicly traded partnerships*.
3. If you were a real estate professional and you materially participated in the activity, report box 2 income (loss) on Schedule E (Form 1040), line 28, column (h) or (j).
4. If you have income from a passive activity in box 2, enter the income on Schedule E, line 28, column (g). However, if the box in item D is checked, report the loss following the rules for *Publicly traded partnerships*.

Box 3. Other Net Rental Income (Loss)

The amount in box 3 is a passive activity amount for all partners. If the partnership had more than one rental activity, it will attach a statement that will identify the amount of income or loss from each activity. Report the income or loss as follows.

1. If box 3 is a loss, follow the instructions for Form 8582 to figure how much of the loss can be reported on Schedule E, line 28, column (f). However, if the box in item D is checked, report the loss following the rules for *Publicly traded partnerships*.
2. If income is reported on box 3, report the income on Schedule E (Form 1040), line 28, column (g). However, if the box in item D is checked, report the income following the rules for *Publicly traded partnerships*.

Box 4. Guaranteed Payments

Generally, amounts on this line are not passive income, and you should report them on Schedule E (Form 1040), line 28, column (j) (for example, guaranteed payments for personal services).

PORTFOLIO INCOME

Portfolio income or loss (shown in boxes 5 through 9b and in box 11, code A) is not subject to the passive activity limitations. Portfolio income includes income not derived in the ordinary course of a trade or business from interest, ordinary dividends, annuities, or royalties and gain or loss on the sale of property that produces such income or is held for investment.

Box 5. Interest Income

Report interest income on line 8a of Form 1040. If the amount of interest income included in box 5 includes interest from the credit for holders of clean renewable energy bonds or Midwestern tax credit bonds, the partnership will attach a statement to Schedule K-1 showing your distributive share of interest income from these credits. Because the basis in your interest in the partnership has been increased by your distributive share of the interest income from these credits, you must reduce your basis by the same amount. See line 4 of the *Worksheet for Adjusting the Basis of a Partner's Interest in the Partnership*.

Box 6a. Ordinary Dividends

Report ordinary dividends on line 9a of Form 1040.

Box 6b. Qualified Dividends

Report any qualified dividends on line 9b of Form 1040.

Note: Qualified dividends are excluded from investment income, but you may elect to include part or all of these amounts in investment income. See the instructions for line 4g of Form 4952, Investment Interest Expense Deduction, for important information on making this election.

Box 7. Royalties

Report royalties on Schedule E (Form 1040) line 4.

Box 8. Net Short-Term Capital Gain (Loss)

Report the net short-term capital gain (loss) on Schedule D (Form 1040) line 5.

Box 9a. Net Long-Term Capital Gain (Loss)

Report the net long-term capital gain (loss) on Schedule D (Form 1040) line 12.

Box 9b. Collectibles (28%) Gain (Loss)

Your share of any collectibles gain or loss. Include this amount on line 4 of the *28% Rate Gain Worksheet* in the instructions for Schedule D (Form 1040), line 18.

Box 9c. Unrecaptured Section 1250 Gain

There are three types of unrecaptured section 1250 gain. Report your share of this unrecaptured gain on the *Unrecaptured Section 1250 Gain Worksheet* in the instructions for Schedule D (Form 1040) as follows.

- Report unrecaptured section 1250 gain from the sale or exchange of the partnership's business assets on line 5.
- Report unrecaptured section 1250 gain from the sale or exchange of an interest in a partnership on line 10.
- Report unrecaptured section 1250 gain from an estate, trust, regulated investment company (RIC), or real estate investment trust (REIT) on line 11.

If the partnership reports only unrecaptured section 1250 gain from the sale or exchange of its business assets, it will enter a dollar amount in box 9c. If it reports the other two types of unrecaptured gain, it will provide an attached statement that shows the amount for each type of unrecaptured section 1250 gain.

Box 10. Net Section 1231 Gain (Loss)

The amount in box 10 is generally passive if it is from a:

- Rental activity, or
- Trade or business activity in which you did not materially participate.

However, an amount from a rental real estate activity is not from a passive activity if you were a real estate professional and you materially participated in the activity.

If the amount is either (a) a loss that is not from a passive activity or (b) a gain, report it on line 2, column (g), of Form 4797, Sales of Business Property. Do not complete columns (b) through (f) on line 2. Instead, write "From Schedule K-1 (Form 1065)" across these columns.

If the amount is a loss from a passive activity, see *Passive loss limitations* in the Instructions for Form 4797. You will need to report the loss following the Instructions for Form 8582 to figure how much of the loss is allowed on Form 4797. However, if the box in item D is checked, report the loss following the rules for *Publicly traded partnerships*. If the partnership had net section 1231 gain (loss) from more than one activity, it will attach a statement that will identify the amount of section 1231 gain (loss) from each activity.

Box 11. Other Income (Loss)

Code A. Other portfolio income (loss). The partnership will report portfolio income other than interest, ordinary dividend, royalty, and capital gain (loss) income. It will attach a statement to tell you what kind of portfolio income is reported.

If the partnership has a residual interest in a real estate mortgage investment conduit (REMIC), it will report on the statement your share of REMIC taxable income (net loss) that you report on Schedule E (Form 1040), line 38, column (d). The statement will also report your share of any “excess inclusion” that you report on Schedule E, line 38, column (c), and your share of section 212 expenses that you report on Schedule E, line 38, column (e). If you itemize your deductions on Schedule A (Form 1040), you may also deduct these section 212 expenses as a miscellaneous deduction subject to the 2% limit on Schedule A, line 23.

Code B. Involuntary conversions. This is your net gain (loss) from involuntary conversions due to casualty or theft. The partnership will give you a schedule that shows the amounts to be entered on Form 4684, Casualties and Thefts, line 37, columns (b)(i), (b)(ii), and (c).

If there was a gain (loss) from a casualty or theft to property not used in a trade or business or for income-producing purposes, the partnership will provide you with the information you need to complete Form 4684.

Code C. Section 1256 contracts & straddles. The partnership will report any net gain or loss from section 1256 contracts. Report this amount on Form 6781, Gains and Losses From Section 1256 Contracts and Straddles.

Code D. Mining exploration costs recapture. The partnership will give you a schedule that shows the information needed to recapture certain mining exploration costs (section 617).

Code E. Cancellation of debt. Generally, this amount is included in your gross income (Form 1040, line 21). Under section 108(b)(5), you may elect to apply any portion of this cancellation of debt to the reduction of the basis of depreciable property. See Form 982 for more details.

Code F. Other income (loss). Amounts with code F are other items of income, gain, or loss not included in boxes 1 through 10 or reported in box 11 using codes A through E. The partnership should give you a description and the amount of your share for each of these items.

Report loss items that are passive activity amounts to you following the Instructions for Form 8582. However, if the box in item D is checked, report the loss following the rules for *Publicly traded partnerships*.

Code F items may include the following:

- Gain or loss attributable to the sale or exchange of qualified preferred stock of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). The partnership will report on an attached statement the amount of gain or loss attributable to the sale or exchange of the qualified preferred stock, the date the stock was acquired by the partnership, and the date the stock was sold or exchanged by the partnership. If the partner is not a financial institution (as defined below), report the gain or loss on line 5 or line 12 of Schedule D (Form 1040) in accordance with the instructions for Schedule D. If a partner is a financial institution referred to in section 582(c)(2) or a depository institution holding company (as defined in

section 3(w)(1) of the Federal Deposit Insurance Act), report the gain or loss in accordance with the Instructions for Form 4797 and Rev. Proc. 2008-64, 2008-47 I.R.B. 1195.

- Partnership gains from the disposition of farm recapture property (see the instructions for line 27 of Form 4797) and other items to which section 1252 applies.
- Income from recoveries of tax benefit items. A tax benefit item is an amount you deducted in a prior tax year that reduced your income tax. Report this amount on line 21 of Form 1040 to the extent it reduced your tax.
- Gambling gains and losses.
 1. If the partnership was not engaged in the trade or business of gambling, (a) report gambling winnings on Form 1040, line 21 and (b) deduct gambling losses to the extent of winnings on Schedule A (Form 1040), line 28.
 2. If the partnership was engaged in the trade or business of gambling, (a) report gambling winnings on line 28 of Schedule E and (b) deduct gambling losses (to the extent of winnings) on line 28 of Schedule E, column (h).
- Gain (loss) from the disposition of an interest in oil, gas, geothermal, or other mineral properties. The partnership will give you an attached statement that provides a description of the property, your share of the amount realized from the disposition, your share of the partnership's adjusted basis in the property (for other than oil or gas properties), and your share of the total intangible drilling costs, development costs, and mining exploration costs (section 59(e) expenditures) passed through for the property. You must determine the amount of gain or loss from the disposition by increasing your share of the adjusted basis by the amount of intangible drilling costs, development costs, or mine exploration costs for the property that you capitalized (that is, costs that you did not elect to deduct under section 59(e)). Report a loss in Part I of Form 4797. Report a gain in Part III of Form 4797 in accordance with the instructions for line 28.
- Any income, gain, or loss to the partnership under section 751(b). Report this amount on Form 4797, line 10.
- Specially allocated ordinary gain (loss). Report this amount on Form 4797, line 10.
- Net short-term capital gain (loss) and net long-term capital gain (loss) from Schedule D (Form 1065) that is not portfolio income. An example is gain or loss from the disposition of nondepreciable personal property used in a trade or business activity of the partnership. Report total net short-term gain (loss) on Schedule D (Form 1040), line 5. Report the total net long-term gain (loss) on Schedule D (Form 1040), line 12.
- Current year section 108(i) cancellation of debt (COD) income. The partnership will provide your distributive share of the deferred COD income amount that you must include in income in the current tax year under section 108(i)(1) or section 108(i)(5)(D)(i) or (ii).
- Gain from the sale or exchange of qualified small business stock (as defined in the Instructions for Schedule D) that is eligible for the partial section 1202 exclusion. The partnership should also give you the name of the corporation that issued the QSB stock, your distributive share of the partnership's adjusted basis and sales price of the QSB stock, and the dates the QSB stock was bought and sold. Corporate partners are not eligible for the section 1202 exclusion. The following additional limitations apply at the partner level:

1. You must have held an interest in the partnership when the partnership acquired the qualified small business stock and at all times thereafter until the partnership disposed of the qualified small business stock.
2. Your distributive share of the eligible section 1202 gain cannot exceed the amount that would have been allocated to you based on your interest in the partnership at the time the stock was acquired.

See the Instructions for Schedule D (Form 1040) for details on how to report the gain and the amount of the allowable exclusion.

- Gain eligible for section 1045 rollover.

Replacement stock purchased by the partnership. The partnership should give you: (a) the name of the corporation that issued the qualified small business (QSB) stock, (b) your share of the partnership's adjusted basis and sales price of the QSB stock, (c) the dates the QSB stock was bought and sold, (d) your distributive share of gain from the sale of the QSB stock, and (e) your distributive share of the gain that was deferred by the partnership under section 1045. Corporate partners are not eligible for the section 1045 rollover. To qualify for the section 1045 rollover:

1. You must have held an interest in the partnership during the entire period in which the partnership held the qualified small business stock (more than 6 months prior to the sale) and
2. Your distributive share of the gain eligible for the section 1045 rollover cannot exceed the amount that would have been allocated to you based on your interest in the partnership at the time the stock was acquired.

See the Instructions for Schedule D (Form 1040) for details on how to report the gain and the amount of the allowable postponed gain.

Opting out of partnership election. You can opt out of the partnership's section 1045 election and either: (1) recognize the gain, or (2) elect to purchase different replacement QSB stock, either directly or through ownership of a partnership that acquired replacement QSB stock. You satisfy the requirement to purchase replacement QSB stock if you own an interest in a partnership that purchases QSB stock during the 60-day period. You also must notify the partnership, in writing, if you opt out of the partnership's section 1045 election. If you recognize gain, you must notify the partnership, in writing, of the amount of the gain that you are recognizing.

Replacement stock not purchased by the partnership. The partnership should give you (a) the name of the corporation that issued the qualified small business (QSB) stock, (b) your share of the partnership's adjusted basis and sales price of the QSB stock, (c) the dates the QSB stock was bought and sold, and (d) your distributive share of gain from the sale of the QSB stock. Corporate partners are not eligible for the section 1045 rollover. To qualify for the section 1045 rollover:

1. You must have held an interest in the partnership during the entire period in which the partnership held the qualified small business stock (more than 6 months prior to the sale),
2. Your distributive share of the gain eligible for the section 1045 rollover cannot exceed the amount that would have been allocated to you based on your interest in the partnership at the time the stock was acquired, and

3. You must purchase other qualified small business stock (as defined in the Instructions for Schedule D (Form 1040)) during the 60-day period that began on the date the stock was sold by the partnership.

See the Instructions for Schedule D (Form 1040) for details on how to report the gain and the amount of the allowable postponed gain.

Making the section 1045 election. You make a section 1045 election on a timely filed return for the tax year during which the partnership tax year ends. Attach to your Schedule D (Form 1040) a statement that includes the following information for each amount of gain that you do not recognize under section 1045:

- The name of the corporation that issued the QSB stock.
- The name and EIN of the selling partnership.
- The dates the QSB stock was purchased and sold.
- The amount of gain that is not recognized under section 1045.
- If a partner purchases QSB stock, the name of the corporation that issued the replacement QSB stock, the date the stock was purchased, and the cost of the stock.
- If a partner treats the partner's interest in QSB stock that is purchased by a purchasing partnership, the name of the corporation that issued the QSB stock, the partner's share of the cost of the QSB stock that was purchased by the partnership, the computation of the partner's adjustment to basis with respect to that QSB stock, and the date the stock was purchased by the partnership.

Distribution of replacement QSB stock to a partner that reduces another partner's interest in replacement QSB stock. You must recognize gain upon a distribution of replacement QSB stock to another partner that reduces your share of the replacement QSB stock held by a partnership. The amount of gain that you must recognize is based on the amount of gain that you would recognize upon a sale of the distributed replacement QSB for its fair market value on the date of the distribution, but not to exceed the amount you previously deferred under section 1045 with respect to the distributed replacement QSB stock. If the partnership distributed your share of replacement QSB stock to another partner, the partnership should give you (a) the name of the corporation that issued the replacement QSB stock, (b) the date the replacement QSB stock was distributed to another partner or partners, and (c) your share of the partnership's adjusted basis and fair market value of the replacement QSB stock on such date.

DEDUCTIONS

Box 12. Section 179 Deduction

Use this amount, along with the total cost of section 179 property placed in service during the year from other sources, to complete Part I of Form 4562, Depreciation and Amortization. The partnership will report on an attached statement your allowable share of the cost of any qualified enterprise zone, renewal community, qualified section 179 Recovery Assistance, qualified section 179 disaster assistance property, or qualified real property it placed in service during the tax year. Report the amount on line 12 of Form 4562 allocable to a passive activity from the partnership using the Instructions for Form 8582. If the amount is not a passive activity deduction, report it on Schedule E (Form

1040), line 28, column (i). However, if the box in item D is checked, report this amount following the rules for *Publicly traded partnerships*.

Box 13. Other Deductions

Contributions. Codes A through G. The partnership will give you a schedule that shows the amount of contributions subject to the 50%, 30%, and 20% adjusted gross income limitations.

Charitable contribution deductions are not taken into account in figuring your passive activity loss for the year. Do not enter them on Form 8582.

Code A. Cash contributions (50%). Enter this amount subject to the 50% AGI limitation on line 16 of Schedule A (Form 1040).

Code B. Cash contributions (30%). Report this amount, subject to the 30% AGI limitation, on line 16 of Schedule A (Form 1040).

Code C. Noncash contributions (50%). If property other than cash is contributed and if the claimed deduction for one item or group of similar items of property exceeds \$5,000, the partnership must give you a copy of Form 8283, Noncash Charitable Contributions, to attach to your tax return. Do not deduct the amount shown on this form. It is the partnership's contribution. Instead, deduct the amount identified by code C, box 13, subject to the 50% AGI limitation, on line 17 of Schedule A (Form 1040).

If the partnership provides you with information that the contribution was property other than cash and does not give you a Form 8283, see the Instructions for Form 8283 for filing requirements. Do not file Form 8283 unless the total claimed deduction for all contributed items of property exceeds \$500.

Food inventory contributions. The partnership will report on an attached statement your distributive share of qualified food inventory contributions. The food inventory contribution is not included in the amount reported in box 13 using code C. The partnership will also report your distributive share of the partnership's net income from the business activities that made the food inventory contribution(s). Your deduction for food inventory contributions cannot exceed 10 percent of your aggregate net income for the tax year from the business activities from which the food inventory contribution was made (including your share of net income from partnership or S corporation businesses that made food inventory contributions). Report the deduction for the food inventory contribution on line 17 of Schedule A (Form 1040).

Code D. Noncash contributions (30%). Report this amount, subject to the 30% AGI limitation, on line 17 of Schedule A (Form 1040).

Code E. Capital gain property to a 50% organization (30%). Report this amount, subject to the 30% AGI limitation, on line 17 of Schedule A (Form 1040).

Code F. Capital gain property (20%). Report this amount, subject to the 20% AGI limitation, on line 17 of Schedule A (Form 1040).

Code G. Contributions (100%). The partnership will report your distributive share of qualified conservation contributions of property used in agriculture or livestock production. This contribution is not included in the amount reported in box 13 using code C. If you are a farmer or rancher, you qualify for a 100% AGI limitation for this contribution. Otherwise, your deduction for this contribution is subject to a 50% AGI limitation. Report this deduction on line 17 of Schedule A (Form 1040). See Pub. 526 for more information on qualified conservation contributions.

Code H. Investment interest expense. Enter this amount on Form 4952, line 1. If the partnership has investment income or other investment expense, it will report your share of these items in box 20 using codes A and B. Include investment income and expenses from other sources to figure how much of your total investment interest is deductible. You will also need this information to figure your investment interest expense deduction.

If the partnership paid or accrued interest on debts properly allocable to investment property, the amount of interest you are allowed to deduct may be limited.

Code I. Deductions – royalty income. Enter deductions allocable to royalties on Schedule E (Form 1040), line 18. For this type of expense, write “From Schedule K-1 (Form 1065).”

These deductions are not taken into account in figuring your passive activity loss for the year. Do not enter them on Form 8582.

Code J. Section 59(e)(2) expenditures. On an attached statement, the partnership will show the type and the amount of qualified expenditures to which an election under section 59(e) may apply. The statement will also identify the property for which the expenditures were paid or incurred. If there is more than one type of expenditure, the amount of each type will also be listed.

If you deduct these expenditures in full in the current year, they are treated as adjustments or tax preference items for purposes of alternative minimum tax. Generally, section 59(e) allows each partner to elect to amortize these expenditures over the number of years in the applicable period rather than deduct the full amount in the current year. If you make this election, these items are not treated as adjustments or tax preference items.

Under this election, you may deduct circulation expenditures ratably over a 3-year period. Research and experimental expenditures and mining exploration and development costs may be amortized over a 10-year period. Intangible drilling and development costs may be amortized over a 60-month period, beginning with the month in which such costs were paid or incurred.

Make the election on Form 4562. If you make the election, report the current year amortization of section 59(e) expenditures from Part VI of Form 4562 on line 28 of Schedule E (Form 1040). If you do not make the election, report the section 59(e)(2) expenditures on line 28 of Schedule E (Form 1040) and compute the resulting adjustment or tax preference item (see Form 6251, Alternative Minimum Tax—

Individuals). Whether you deduct the expenditures or elect to amortize them, report the amount on a separate line in column (h) of line 28 if you materially participated in the partnership activity. If you did not materially participate, follow the Instructions for Form 8582 to figure how much of the deduction can be reported in column (f).

Code K. Deductions – portfolio (2% floor). Amounts entered with code J are deductions that are clearly and directly allocable to portfolio income (other than investment interest expense and section 212 expenses from a REMIC). Generally, you should enter these amounts on Schedule A (Form 1040), line 23. See the instructions for Schedule A, lines 23 and 28, for more information.

These deductions are not taken into account in figuring your passive activity loss for the year. Do not enter them on Form 8582.

Code L. Deductions – portfolio (other). Generally, you should enter these amounts on Schedule A (Form 1040), line 28. See the instructions for Schedule A, lines 23 and 28, for more information. These deductions are not taken into account in figuring your passive activity loss for the year. Do not enter them on Form 8582.

Code M. Amounts paid for medical insurance. Any amounts paid during the tax year for insurance that constitutes medical care for you, your spouse, your dependents, and any children under age 27 who are not dependents. On line 29 of Form 1040, you may be allowed to deduct such amounts, even if you do not itemize deductions. If you do itemize deductions, enter on line 1 of Schedule A (Form 1040) any amounts not deducted on line 29 of Form 1040.

Code N. Educational assistance benefits. Deduct your educational assistance benefits on a separate line of Schedule E, line 28, up to the \$5,250 limitation. If your benefits exceed \$5,250, you may be able to use the excess amount on Form 8863 to figure the education credits.

Code O. Dependent care benefits. The partnership will report the dependent care benefits you received. You must use Form 2441, Part III, to figure the amount, if any, of the benefits you may exclude from your income.

Code P. Preproductive period expenses. You may be eligible to elect to deduct these expenses currently or capitalize them under section 263A.

Code Q. Commercial revitalization deductions from rental real estate activities. Follow the instructions for Form 8582 to figure how much of the deduction can be reported on Schedule E, line 28, column (f).

Code R. Pensions and IRAs. Payments made on your behalf to an IRA, qualified plan, simplified employee pension (SEP), or a SIMPLE IRA plan. See Form 1040 instructions for line 32 to figure your IRA deduction. Enter payments made to a qualified plan, SEP, or SIMPLE IRA plan on Form 1040, line 28. If the payments to a qualified plan were to a defined benefit plan, the partnership should give you a statement showing the amount of the benefit accrued for the current tax year.

Code S. Reforestation expense deduction. The partnership will provide a statement that describes the qualified timber property for these reforestation expenses. Generally, the expense deduction is limited to \$10,000 (\$5,000 if married filing separately) for each qualified timber property, including your distributive share of the partnership's expense and any reforestation expenses you separately paid or incurred during the tax year.

If you did not materially participate in the activity, use Form 8582 to determine how much of these expenses can be reported on Schedule E (Form 1040), line 28. If you materially participated in the reforestation activity, report the deduction on line 28, column (h), of Schedule E (Form 1040).

Code T. Domestic production activities information. The partnership will provide you with a statement with information that you must use to figure the domestic production activities deduction. Use Form 8903, Domestic Production Activities Deduction, to figure this deduction. See the Instructions for Form 8903 for more details.

Code U. Qualified production activities income (QPAI). Report the QPAI reported to you by the partnership (in box 13 of Schedule K-1) on line 7 of Form 8903.

Code V. Employer's W-2 wages. Report the portion of W-2 wages reported to you by the partnership (in box 13 of Schedule K-1) on line 17 of Form 8903.

Code W. Other deductions. Amounts with this code may include:

- Itemized deductions (Form 1040 filers enter on Schedule A (Form 1040)).
- Soil and water conservation expenditures. See section 175 for limitations on the amount you are allowed to deduct.
- Expenditures for the removal of architectural and transportation barriers to the elderly and disabled that the partnership elected to treat as a current expense. The deductions are limited by section 190(c) to \$15,000 per year from all sources.
- Interest expense allocated to debt-financed distributions. The manner in which you report such interest expense depends on your use of the distributed debt proceeds. If the proceeds were used in a trade or business activity, report the interest on line 28 of Schedule E (Form 1040). In column (a) enter the name of the partnership and "interest expense." If you materially participated in the trade or business activity, enter the amount of interest expense in column (h). If you did not materially participate in the activity, follow the instructions for Form 8582 to determine the amount of interest expense you can report in column (f). If the proceeds were used in an investment activity, enter the interest on Form 4952. If the proceeds are used for personal purposes, the interest is generally not deductible.
- Interest paid or accrued on debt properly allocable to your share of a working interest in any oil or gas property (if your liability is not limited). If you did not materially participate in the oil or gas activity, this interest is investment interest reportable, as described previously; otherwise, it is trade or business interest. If you did not materially participate in the oil or gas activity, this interest is investment interest expense and should be reported on Form 4952. If you materially participated in the activity, report the interest on line 28 of Schedule E (Form 1040). On a separate line, enter "interest expense" and the name of the partnership in column (a) and the amount in column (h).

- Contributions to a capital construction fund (CCF). The deduction for a CCF investment is not taken on Schedule E (Form 1040). Instead, you subtract the deduction from the amount that would normally be entered as taxable income on line 43 (Form 1040). In the margin to the left of line 43, write “CCF” and the amount of the deduction.
- Penalty on early withdrawal of savings. Report this amount on Form 1040, line 30.
- Film and television production expenses. The partnership will provide a statement that describes the film or television production generating these expenses. Generally, if the aggregate cost of the production exceeds \$15 million, you are not entitled to the deduction. The limitation is \$20 million for productions in certain areas (see section 181 for details). If you did not materially participate in the activity, use Form 8582 to determine the amount that can be reported on Schedule E (Form 1040), line 28, column (f). If you materially participated in the production activity, report the deduction on Schedule E (Form 1040), line 28, column (h).
- Current year section 108(i) original issue discount (OID) deduction. The partnership will provide your distributive share of the partnership’s OID deduction deferred under section 108(i)(2)(A)(i) that is allowable as a deduction in the current tax year under section 108(i)(2)(A)(ii) or section 108(i)(5)(D)(i) or (ii).

The partnership will give you a description and the amount of your share for each of these items.

Box 14. Self-Employment Earnings (Loss)

If you and your spouse are both partners, each of you must complete and file your own Schedule SE (Form 1040), Self-Employment Tax, to report your partnership net earnings (loss) from self-employment.

Code A. Net earnings (loss) from self-employment. If you are a general partner, reduce this amount before entering it on Schedule SE (Form 1040) by any section 179 expense deduction claimed, unreimbursed partnership expenses claimed, and depletion claimed on oil and gas properties. Do not reduce net earnings from self-employment by any separately stated deduction for health insurance expenses.

If the amount on this line is a loss, enter only the deductible amount on Schedule SE (Form 1040). See *Limitations on Losses, Deductions, and Credits*.

If your partnership is an options dealer or a commodities dealer, see section 1402(i).

Code B. Gross farming or fishing income. If you are an individual partner, enter the amount from this line, as an item of information, on Schedule E (Form 1040), line 42. Also use this amount to figure net earnings from self-employment under the farm optional method on Schedule SE (Form 1040), Section B, Part II.

Code C. Gross non-farm income. If you are an individual partner, use this amount to figure net earnings from self-employment under the nonfarm optional method on Schedule SE (Form 1040), Section B, Part II.

Box 15. Credits

If you have general business credits, the partnership will provide the information necessary for you to determine if it is an eligible small business under section 38(c)(5)(C). If you and the partnership meet the requirements of section 38(c)(5)(C), your general business credits may be treated as eligible small business credits.

If you have credits that are passive activity credits to you, you must complete Form 8582-CR (or Form 8810 for corporations) in addition to the credit forms identified below.

Tip. In general, partners whose only source for credits listed on page 1 of Form 3800 are from pass-through entities are not required to complete the source credit form or attach it to Form 3800. Instead, you can report this credit directly on Form 3800. However, there are two exceptions. When applicable, all partners must complete and attach the following credit forms to Form 3800.

- Form 3468, Investment Credit (line 1a of Form 3800).
- Form 8864, Biodiesel and Renewable Diesel Fuels Credit (line 1l of Form 3800).

Codes A, B, C and D. Low-income housing credit. If section 42(j)(5) applies, the partnership will report your share of the low-income housing credit using code A or code C, depending on the date when the building was placed in service. If section 42(j)(5) does not apply, your share of the credit will be reported using code B. Any allowable low-income housing credit will be reported using code B or code D, depending on the date when the building was placed in service. Any allowable low-income housing credit reported using code A or code B is entered on line 4 of Form 8586, Low-Income Housing Credit, or line 1d of Form 3800 (see tip above). Any allowable low-income housing credit reported using code C or code D is entered on line 11 of Form 8586.

Keep a separate record of the amount of low-income housing credit from each of these sources so that you can correctly compute any recapture of low-income housing credit that may result from the disposition of all or part of your partnership interest.

Code E. Qualified rehabilitation expenditures (rental real estate). The partnership will report your share of the qualified rehabilitation expenditures and other information you need to complete Form 3468 related to rental real estate activities using code E. Your share of qualified rehabilitation expenditures from property not related to rental real estate activities will be reported in box 20 using code D. See Form 3468 for details. If the partnership is reporting expenditures from more than one activity, the attached statement will separately identify the amount of expenditures from each activity.

Combine the expenditures (for Form 3468 reporting) from box 15, code E and box 20, code D. The expenditures related to rental real estate activities (box 15, code E) are reported on Schedule K-1 separately from other qualified rehabilitation expenditures (box 20, code D) because they are subject to different passive activity limitation rules. See the instructions for Form 8582-CR for details.

Code F. Other rental real estate credits. The partnership will identify the type of credit and any other information you need to compute credits from rental real estate activities (other than the low-income housing credit and qualified rehabilitation expenditures). These credits may be limited by the passive activity limitations. If the credits are from

more than one activity, the partnership will identify the amount of credits from each activity on an attached statement.

Code G. Other rental credits. The partnership will identify the type of credit and any other information you need to compute these rental credits. These credits may be limited by the passive activity limitations. If the credits are from more than one activity, the partnership will identify the amount of credits from each activity on an attached statement.

Code H. Undistributed capital gains credit. Code H represents taxes paid on undistributed capital gains by a regulated investment company or real estate investment trust. Form 1040 filers enter your share of these taxes on line 71 of Form 1040, check box "a" for Form 2439, and enter "Form 1065."

Code I. Alcohol and cellulosic biofuel fuels credit. If this credit includes the small ethanol producer credit, the partnership will provide additional information on an attached statement. If no statement is attached, report this amount on line 8 of Form 6478, Alcohol and Cellulosic Biofuel Fuels Credit. If a statement is attached, see the instructions for Form 6478, line 8.

Code J. Work opportunity credit. Report this amount on line 3 of Form 5884, Work Opportunity Credit.

Code K. Disabled access credit. Report this amount on line 7 of Form 8826, Disabled Access Credit, or line 1e of Form 3800.

Code L. Empowerment zone and renewal community employment credit. Report this amount on line 3 of Form 8844, Empowerment Zone and Renewal Community Employment Credit.

Code M. Credit for increasing research activities. Report this amount on line 37 of Form 6765, Credit for Increasing Research Activities, or line 1c of Form 3800.

Code N. Credit for employer social security and Medicare taxes. Report this amount on line 5 of Form 8846, Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips.

Code O. Backup withholding. This is your share of the credit for backup withholding on dividends, interest income, and other types of income. Include this amount in the total that you enter on Form 1040, line 61, and attach a copy of the Schedule K-1 to your tax return.

Code P. Other credits. On an attachment to Schedule K-1, the partnership will identify the type of credit and any other information you need to compute credits other than those reported with codes A through O. Most credits identified by code P will be reported on Form 3800.

Credits that may be reported with code P include the following:

- New markets credit (Form 8874).
- Nonconventional source fuel credit (Form 8907).

- Qualified railroad track maintenance credit (Form 8900).
- Unused investment credit from the qualifying advanced coal project credit, qualifying gasification project credit, qualifying advanced energy project credit, or qualified therapeutic discovery project credit allocated from cooperatives (Form 3468, line 9).
- Unused investment credit from the rehabilitation credit or energy credit allocated from cooperatives (Form 3468, line 13).
- Renewable electricity, refined coal, and Indian coal production credit. The partnership will provide a statement showing separately the amount of credit from Part I and Part II of Form 8835.
- Indian employment credit (Form 8845).
- Orphan drug credit (Form 8820).
- Credit for small employer pension plan startup costs (Form 8881).
- Credit for employer-provided childcare facilities and services (Form 8882).
- Biodiesel and renewable diesel fuels credit. If this credit includes the small agri-biodiesel producer credit, the partnership will provide additional information on an attached statement. If no statement is attached, report this amount on line 9 of Form 8864. If a statement is attached, see the instructions for Form 8864, line 9.
- Low sulfur diesel fuel production credit (Form 8896).
- General credits from an electing large partnership. Report these credits on Form 3800, line 1bb.
- Distilled spirits credit (Form 8906).
- Energy efficient home credit (Form 8908).
- Energy efficient appliance credit (Form 8909).
- Alternative motor vehicle credit (Form 8910).
- Alternative fuel vehicle refueling property credit (Form 8911).
- Clean renewable energy bond credit. Report this amount on Form 8912.
- Midwestern tax credit bond credit. Report this amount on Form 8912.
- New clean renewable energy bond credit. Report this amount on Form 8912.
- Qualified energy conservation bond credit. Report this amount on Form 8912.
- Qualified forestry conservation bond credit. Report this amount on Form 8912.
- Qualified zone academy bond credit. Report this amount on Form 8912.
- Qualified school construction bond credit. Report this amount on Form 8912.
- Build America bond credit. Report this amount on Form 8912.
- Mine rescue team training credit (Form 8923).
- Agricultural chemicals security credit (Form 8931).
- Credit for employer differential wage payments (Form 8932).
- Carbon dioxide sequestration credit (Form 8933).
- Qualified plug-in electric drive motor vehicle credit (Form 8936).
- Qualified plug-in electric vehicle credit (Part I of Form 8834).
- Credit for small employer health insurance premiums (Form 8941).
- New hire retention credit (Form 5884-B).

Box 16. Foreign Transactions

Codes A through N. Use the information reported as codes A through N, code Q and attached schedules to figure your foreign tax credit.

Codes O and P. Extraterritorial income exclusion.

1. *Partnership did not claim the exclusion.* If the partnership reports your distributive share of foreign trading gross receipts (code O) and the extraterritorial income exclusion (code P), the partnership was not entitled to claim the exclusion because it did not meet the foreign economic process requirements. You may still qualify for your distributive share of this exclusion if the partnership's foreign trading gross receipts for the tax year were \$5 million or less. To qualify for this exclusion, your foreign trading gross receipts from all sources for the tax year also must have been \$5 million or less. If you qualify for the exclusion, report the exclusion amount in accordance with the instructions for *Income (Loss)* for box 1, 2, or 3, whichever applies. See Form 8873, Extraterritorial Income Exclusion, for more information.
2. *Partnership claimed the exclusion.* If the partnership reports your distributive share of foreign trading gross receipts but not the amount of the extraterritorial income exclusion, the partnership met the foreign economic process requirements and claimed the exclusion when figuring your distributive share of partnership income. You also may need to know the amount of your distributive share of foreign trading gross receipts from this partnership to determine if you met the \$5 million or less exception discussed above for purposes of qualifying for an extraterritorial income exclusion from other sources.

Note. Upon request, the partnership should furnish you a copy of the partnership's Form 8873 if there is a reduction for international boycott operations, illegal bribes, kickbacks, etc.

Code Q. Other foreign transactions. On an attachment to Schedule K-1, the partnership will report any other information on foreign transactions that you may need using code Q.

Box 17. Alternative Minimum Tax (AMT) Items

Use the information reported in box 17 (as well as your adjustments and tax preference items from other sources) to prepare your Form 6251, Alternative Minimum Tax – Individuals; Form 4626, Alternative Minimum Tax – Corporations; or Schedule I (Form 1041), Alternative Minimum Tax – Estates and Trusts.

Note. A partner that is a corporation subject to alternative minimum tax must notify the partnership of its status.

Code A. This amount is your share of the partnership's post-1986 depreciation adjustment. If you are an individual partner, report this amount on line 18 of Form 6251.

Code B. This amount is your share of the partnership's adjusted gain or loss. If you are an individual partner, report this amount on line 17 of Form 6251.

Code C. This amount is your share of the partnership's depletion adjustment. If you are an individual partner, report this amount on line 9 of Form 6251.

Codes D and E. Oil, gas, & geothermal properties – gross income and deductions.

The amounts reported on these lines include only the gross income (code D) from, and deductions (code E) allocable to, oil, gas, and geothermal properties that are included in box 1 of Schedule K-1. The partnership should have attached a schedule that shows any income from or deductions allocable to such properties that are included in boxes 2 through 13, 18, and 20 of Schedule K-1. Use the amounts reported and the amounts on the attached schedule to help you figure the net amount to enter on line 26 of Form 6251.

Code F. Other AMT items. Enter the information on the statement attached by the partnership on the applicable lines of Form 6251, Form 4626, or Schedule I (Form 1041).

Box 18. Tax-Exempt Income and Nondeductible Expenses

Code A. Tax-exempt interest income. You must report on your return, as an item of information, your share of the tax-exempt interest received or accrued by the partnership during the year. Individual partners must include this amount on Form 1040, line 8b. Increase the adjusted basis of your interest in the partnership by this amount.

Code B. Other tax-exempt income. Increase the adjusted basis of your interest in the partnership by the amount shown, but do not include it in income on your tax return.

Code C. Nondeductible expenses. The nondeductible expenses paid or incurred by the partnership are not deductible on your tax return. Decrease the adjusted basis of your interest in the partnership by this amount.

Box 19. Distributions

Code A. Cash and marketable securities. Code A shows the distributions the partnership made to you of cash and certain marketable securities. The marketable securities are included at their fair market value (FMV) on the date of distribution (minus your share of the partnership's gain on the securities distributed to you). If the amount shown as code A exceeds the adjusted basis of your partnership interest immediately before the distribution, the excess is treated as gain from the sale or exchange of your partnership interest. Generally, this gain is treated as gain from the sale of a capital asset and should be reported on the Schedule D for your return. However, if you receive cash or property in exchange for any part of a partnership interest, the amount of the distribution attributable to your share of the partnership's unrealized receivable or inventory items result in ordinary income (see Regulations section 1.751-1(a) and *Sale or Exchange of Partnership Interest*).

The partnership will separately identify both of the following.

- The FMV of the marketable securities when distributed (minus your share of the gain on the securities distributed to you).
- The partnership's adjusted basis of those securities immediately before the distribution.

Decrease the adjusted basis of your interest in the partnership (but not below zero) by the amount of cash distributed to you and the partnership's adjusted basis of the distributed securities. Advances or drawings of money or property against your

distributive share are treated as current distributions made on the last day of the partnership's tax year.

Your basis in the distributed marketable securities (other than in liquidation of your interest) is the smaller of:

- The partnership's adjusted basis in the securities immediately before the distribution increased by any gain recognized on the distribution of the securities or
- The adjusted basis of your partnership interest reduced by any cash distributed in the same transaction and increased by any gain recognized on the distribution of the securities.

If you received the securities in liquidation of your partnership interest, your basis in the marketable securities is equal to the adjusted basis of your partnership interest reduced by any cash distributed in the same transaction and increased by any gain recognized on the distribution of the securities.

Code B. Distribution subject to section 737. If a partner contributed section 704(c) built-in gain property within the last 7 years and the partnership made a distribution of property to that partner other than the previously contributed built-in gain property, the partner may be required to recognize gain under section 737. This gain is in addition to any gain recognized under section 731 on the distribution.

When this occurs, the partnership will enter code B in box 19 of the contributing partner's Schedule K-1 and attach a statement that provides the information the partner needs to compute the recognized gain under section 737. The partnership is required to provide the following information.

- The fair market value (FMV) of the distributed property (other than money).
- The amount of money received in the distribution.
- The net precontribution gain of the partner.

Using the information from the attached statement, complete the worksheet below to compute your recognized gain under section 737.

Computation of Section 737 Gain		
1. Enter the FMV of the distributed property (other than money)		\$ _____
2. Enter your adjusted basis in the partnership immediately before the distribution. See <i>Basis Rules</i>	_____	
3. Enter the amount of money received in the distribution	_____	
4. Subtract line 3 from line 2. If zero or less, enter -0-		_____
5. Subtract line 4 from line 1		_____
6. Enter your net precontribution gain		_____
7. Section 737 gain. Enter the lesser of the amount on line 5 or line 6		_____

The type of gain (section 1231 gain, capital gain) generated is determined by the type of gain you would have recognized if you sold the property rather than contributing it to the partnership. Accordingly, report the amount from line 7 above on Form 4797 or Schedule D of your tax return.

Code C. Other property. Code C shows the partnership's adjusted basis of property other than money immediately before the property was distributed to you. In addition, the partnership should report the adjusted basis and FMV of each property distributed. Decrease the adjusted basis of your interest in the partnership by the amount of your basis in the distributed property. Your basis in the distributed property (other than in liquidation of your interest) is the smaller of:

- The partnership's adjusted basis immediately before the distribution or
- The adjusted basis of your partnership interest reduced by any cash distributed in the same transaction.

If you received the property in liquidation of your interest, your basis in the distributed property is equal to the adjusted basis of your partnership interest reduced by any cash distributed in the same transaction.

If you receive cash or property in exchange for any part of a partnership interest, the amount of the distribution attributable to your share of the partnership's unrealized receivable or inventory items result in ordinary income (see Regulations section 1.751-1(a) and *Sale or Exchange of Partnership Interest*).

Box 20. Other Information

Code A. Investment income. Report this amount on line 4a of Form 4952.

Code B. Investment expenses. Report this amount on line 5 of Form 4952.

Code C. Fuel tax credit information. The partnership will report the number of gallons of each fuel sold or used during the tax year for a nontaxable use qualifying for the credit for taxes paid on fuels, type of use, and the applicable credit per gallon. Use this information to complete Form 4136, Credit for Federal Tax Paid on Fuels.

Code D. Qualified rehabilitation expenditures (other than rental real estate). The partnership will report your share of the qualified rehabilitation expenditures and other information you need to complete Form 3468 for property not related to rental real estate activities in box 20 using code D. Your share of qualified rehabilitation expenditures related to rental real estate activities is reported in box 15 using code E. See Form 3468 for details. If the partnership is reporting expenditures from more than one activity, the attached statement will separately identify the amount of expenditures from each activity.

Combine the expenditures (for Form 3468 reporting) from box 15, code E and box 20, code D. The expenditures related to rental real estate activities (box 15, code E) are reported on Schedule K-1 separately from other qualified rehabilitation expenditures (box 20, code D) because they are subject to different passive activity limitation rules. See the instructions for Form 8582-CR for details.

Code E. Basis of energy property. If the partnership provides an attached statement for code E, report the information shown on the statement to complete lines 12a-d, 12f, 12g, 12i, 12j, 12l, 12m, 12o, and 12q-s of Form 3468.

Codes F and G. Recapture of low-income housing credit. A section 42(j)(5) partnership will report recapture of a low-income housing credit with code F. All other partnerships will report recapture of a low-income housing credit with code G. Keep a separate record of recapture from each of these sources so that you will be able to correctly compute any recapture of low-income housing credit that may result from the disposition of all or part of your partnership interest. For more information, see Form 8611.

Code H. Recapture of investment credit. A partnership will provide any information you need to figure your recapture tax on Form 4255, Recapture of Investment Credit. See the Form 3468 on which you took the original credit for other information you need to complete Form 4255.

You may also need Form 4255 if you dispose of more than one-third of your interest in a partnership.

Code I. Recapture of other credits. On an attachment to Schedule K-1, the partnership will report any information you need to figure the recapture of the new markets credit (see Form 8874); qualified plug-in electric and electric vehicle credit (see Form 8834); Indian employment credit (see section 45A(d)); any credit for employer-provided childcare facilities and services (see Form 8882); alternative motor vehicle credit (see section 30B(h)(8)); alternative fuel vehicle refueling property credit (see section 30C(e)(5)); or the new qualified plug-in electric drive motor vehicles credit (see section 30D(f)(5)).

Code J. Look-back interest – completed long-term contracts. The partnership will report any information you need to figure the interest due or to be refunded under the look-back method of section 460(b)(2) on certain long-term contracts. Use Form 8697, Interest Computation Under the Look-Back Method for Completed Long-Term Contracts, to report any such interest.

Code K. Look-back interest – income forecast method. The partnership will report any information you need to figure the interest due or to be refunded under the look-back method of section 167(g)(2) for certain property placed in service after September 13, 1995, and depreciated under the income forecast method. Use Form 8866, Interest Computation Under the Look-Back Method for Property Depreciated Under the Income Forecast Method, to report any such interest.

Code L. Dispositions of property with section 179 deductions. The partnership will report your distributive share of gain or loss on the sale, exchange, or other disposition of property for which a section 179 expense deduction was passed through to partners with code F. If the partnership passed through a section 179 expense deduction to its partners for the property, you must report the gain or loss and any recapture of the section 179 expense deduction for the property on your income tax return (see the Instructions for Form 4797 for details). The partnership must provide all the following information.

1. Description of the property.
2. Date the property was acquired and placed in service.
3. Date of the sale or other disposition of the property.
4. Your distributive share of the gross sales price or amount realized.

5. Your distributive share of the cost or other basis plus the expense of sale.
6. Your distributive share of the depreciation allowed or allowable.
7. Your distributive share of the section 179 expense deduction (if any) passed through for the property and the partnership's tax year(s) in which the amount was passed through. To compute the amount of depreciation allowed or allowable for Form 4797, line 22, add to the amount from item 6 above the amount of your distributive share of the section 179 expense deduction, reduced by any unused carryover of the deduction for this property. This amount may be different than the amount of section 179 expense you deducted for the property if your interest in the partnership has changed.
8. If the disposition is due to a casualty or theft, a statement providing the information you need to complete Form 4684.
9. If the sale was an installment sale made during the partnership's tax year, any information you need to complete Form 6252, Installment Sale Income. The partnership also must separately report your share of all payments received for the property in the following tax years.

Code M. Recapture of section 179 deduction. The partnership will report your distributive share of any recapture of section 179 expense deduction if business use of any property for which the section 179 expense deduction was passed through to partners dropped to 50 percent or less. If business use of the property dropped to 50 percent or less, the partnership must provide all the following information.

1. Your distributive share of the depreciation allowed or allowable (not including the section 179 expense deduction).
2. Your distributive share of the section 179 expense deduction (if any) passed through for the property and the partnership's tax year(s) in which the amount was passed through. Reduce this amount by the portion, if any, of your unused (carryover) section 179 expense deduction for this property.

Code N. Interest expense for corporate partners. The partnership will report each corporate partner's distributive share of the partnership's interest expense. The amount is reported elsewhere on Schedule K-1 and the total amount is reported here for information only. Your distributive share of interest income is reported in box 5 and your share of the partnership's liabilities is reported in Item K, Part II. A corporate partner's distributive share of interest income, interest expense, and partnership liabilities are treated as income, expense, and liabilities of the corporation for purposes of the limitation on the deduction for interest under section 163(j).

Code O. Section 453(l)(3) information. The partnership will report any information you need to figure the interest due under section 453(l)(3) with respect to the disposition of certain timeshares and residential lots on the installment method. If you are an individual, report the interest on Form 1040, line 60. Write "453(l)(3)" and the amount of the interest on the dotted line to the left of line 60.

Code P. Section 453A(c) information. The partnership will report any information you need to figure the interest due under section 453A(c) with respect to certain installment sales. If you are an individual, report the interest on Form 1040, line 60. Enter "453A(c)" and the amount of the interest on the dotted line to the left of line 60. See the Instructions for Form 6252 for more information. Also see section 453A(c) for details on making the computation.

Code Q. Section 1260(b) information. The partnership will report any information you need to figure the interest due under section 1260(b). If the partnership had gain from certain constructive ownership transactions, your tax liability must be increased by the interest charge on any deferral of gain recognition under section 1260(b). Report the interest on Form 1040, line 60. Enter “1260(b)” and the amount of the interest on the dotted line to the left of line 60. See section 1260(b) for details, including how to figure the interest.

Code R. Interest allocable to production expenditures. The partnership will report any information you need relating to interest expense that you are required to capitalize under section 263A for production expenditures.

Code S. CCF nonqualified withdrawals. The partnership will report your nonqualified withdrawals by the partnership from a capital construction fund (CCF). These withdrawals are taxed separately from your other gross income at the highest marginal ordinary income or capital gains tax rate. Attach a statement to your federal income tax return to show your computation of both the tax and interest for a nonqualified withdrawal. Include the tax and interest on Form 1040, line 60. To the left of line 60, enter the amount of tax and interest and “CCF.”

Code T. Information needed to figure depletion – oil and gas. This is your share of gross income from the property, share of production for the tax year, etc., needed to figure your depletion deduction for oil and gas wells. The partnership should also allocate to you a share of the adjusted basis of each partnership oil or gas property.

Code U. Amortization of reforestation costs. The partnership will provide a statement identifying your share of the amortizable basis of reforestation expenditures paid or incurred before October 23, 2004. The partnership will separately report your share of the amortizable basis for reforestation expenditures for 2003 and 2004. Your amortizable basis of reforestation expenditures for each tax year from all properties is limited to \$10,000 (\$5,000 if married filing separately), including your distributive share of the partnership’s expenditures and any qualified reforestation expenditures you separately paid or incurred.

Follow the instructions for Form 8582 to report a deduction allocable to a passive activity. If you materially participated in the reforestation activity, report the deduction on line 28, column (h), of Schedule E (Form 1040).

Code V. Unrelated business taxable income. The partnership will report any information you need to figure unrelated business taxable income under section 512(a)(1) (but excluding any modifications required by paragraphs (8) through (15) of section 512(b)) for a partner that is a tax-exempt organization.

Note. A partner is required to notify the partnership of its tax-exempt status.

Code W. Precontribution gain (loss). If the partnership distributed any contributed property to any partner **other than** the contributing partner, and the date of the distribution was within 7 years of the date the property was contributed to the partnership, the contributing partner must recognize a gain or loss under section 704(c)(1)(B). If the partnership made such a distribution during its tax year, it will enter code W in box 20 of the contributing partner’s Schedule K-1 and attach a statement

providing the amount of the partner's precontribution gain (loss) and identifying the character of the gain or loss (for example, capital gain (loss) or section 1231 gain (loss)). Report the precontribution gain or loss on Schedule D or Form 4797 in accordance with the information provided by the partnership.

Code X. Section 108(i) information. If the partnership made a section 108(i) election or allocates any section 108(i) items to its partners, it will provide a statement identifying your distributive share of the following:

- The deferred section 108(i) cancellation of debt (COD) income that has not been included in income in the current or prior tax years,
- The partnership's original issue discount (OID) deduction deferred under section 108(i)(2)(A)(i) that has not been deducted in the current or prior tax years,
- The deferred section 752 amount that is treated as a distribution of money under section 752 in the current tax year, and
- The deferred section 752 amount remaining as of the end of the current tax year.

Code Y. Other information. The partnership will report:

1. Any information a publicly traded partnership needs to determine whether it meets the 90% qualifying income test of section 7704(c)(2).

Note. A partner is required to notify the partnership of its status as a publicly traded partnership.

2. Any information you need to complete a disclosure statement for reportable transactions in which the partnership participates. If the partnership participates in a transaction that must be disclosed on Form 8886, Reportable Transaction Disclosure Statement, both you and the partnership may be required to file Form 8886 for the transaction. The determination of whether you are required to disclose a transaction of the partnership is based on the category(s) under which the transaction qualifies for disclosure and is determined by the partnership. You may have to pay a penalty if you are required to file Form 8886 and do not do so.
3. Interest and additional tax on compensation deferred under a section 409A nonqualified deferred compensation plan that does not meet the requirements of section 409A. See section 409A(a)(1)(B) to figure the interest and additional tax on this income. Report this interest and tax on line 60 of Form 1040. This income is included in the amount in box 4, Guaranteed Payments.
4. Inversion gain. The partnership will provide a statement showing the amounts of each type of income or gain that is included in inversion gain. The partnership has included inversion gain in income elsewhere on Schedule K-1. Inversion gain is also reported under code Y because your taxable income and alternative minimum taxable income cannot be less than the inversion gain. Also, your inversion gain: (a) is not taken into account in figuring the amount of net operating loss (NOL) for the tax year or the amount of NOL that can be carried over to each tax year, (b) may limit the amount of your credits, and (c) is treated as income from sources within the U.S. for the foreign tax credit.

5. Qualified timber gain (corporate partners only). Report the partner's distributive share of qualified timber gain on the applicable line of your corporate tax return. See section 1201(b) and the instructions for your corporate tax return for more information.
6. Qualifying advanced coal project property. Use the amounts on lines 5a through 5c of Form 3468.
7. Qualifying gasification project property. Use the amounts on Form 3468, lines 6a and 6b.
8. Qualifying advanced energy project property. Use the amount the partnership provides you to figure the amount to report on Form 3468, line 7.
9. Qualifying therapeutic discovery project property. Use the amount the partnership provides you to figure the amount to report on Form 3468, line 8.
10. The information needed to complete Schedule P (Form 1120-F), List of Foreign Partner Interests in Partnerships. When required, the partnership will make this report on an attached statement to partners that are a corporation (identified as a foreign partner under Regulations section 1.1446-1(c)(3)) or partners that are a partnership (domestic or foreign) if the reporting partnership knows, or has reason to know, that one or more of the partners is a foreign corporation. If the partnership allocates effectively connected income to the partner, the statement will contain the information needed to complete lines 1 through 9, 12, 13, 14b, 16a, 16b, and 17 of Sch P (Form 1120-F). If the partnership does not allocate effectively connected income to the partner, the statement will contain the information needed to complete lines 12, 13, and 17 of Schedule P (Form 1120-F).
11. Conservation reserve program payments. Individuals who received social security retirement or disability benefits, and are partners in farm partnerships that receive conservation reserve program payments, do not pay self-employment tax on their portion of the payments. The partnership will report your portion of the conservation reserve program payments in box 20 using code Y. See Schedule SE (Form 1040) for information on excluding the payment from your calculation of self-employment tax.
12. Acceleration of AMT and research credits (corporations only). If a corporate partner has made an election to accelerate the AMT and research credits in lieu of bonus depreciation, it is required to notify the partnership of this election. The partnership is required to recompute the electing corporate partner's distributive share of depreciation on any eligible qualified property to eliminate bonus depreciation and use the straight line depreciation method for such property. The partnership will attach a statement to Schedule K-1 that lists each partnership item that includes bonus depreciation and shows the electing corporate partner's adjustment for each item that results from the recomputed depreciation and elimination of the bonus depreciation. The partner must reduce the amount shown on Schedule K-1 for these partnership items by the amount of the corresponding adjustment. See section 168(k)(4) for more information.
13. Any other information you may need to file your return not shown elsewhere on Schedule K-1.

14. Eligible small business credits. General business credits (credits reported under box 15, box 20 using codes D and E, and box 20 using code Y for items 6 through 9), that are determined after 2009 and attributable to an eligible small business may be used to offset tentative minimum tax and qualify for a 5-year carryback. An eligible small business is a business with average annual gross receipts for the three preceding tax years of \$50 million or less. To qualify for the eligible small business credit, both you and the partnership must meet the gross receipts test of section 38(c)(5)(C). The partnership will provide the information you need to determine if it is an eligible small business. For more information on eligible small business credits, see Form 3800.
15. Any other information you may need to file your return not shown elsewhere on Schedule K-1.

The partnership should give you a description and the amount of your share for each of these items.

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

Department of the Treasury
Internal Revenue Service

2010

For calendar year 2010, or tax
year beginning _____, 2010
ending _____, 20____

Final K-1 Amended K-1

651110
OMB No. 1545-0099

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

Part I Information About the Partnership		Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items																									
A Partnership's employer identification number		1 Ordinary business income (loss)	15 Credits																								
B Partnership's name, address, city, state, and ZIP code		2 Net rental real estate income (loss)																									
C IRS Center where partnership filed return		3 Other net rental income (loss)	16 Foreign transactions																								
D <input type="checkbox"/> Check if this is a publicly traded partnership (PTP)		4 Guaranteed payments																									
Part II Information About the Partner		5 Interest income																									
E Partner's identifying number		6a Ordinary dividends																									
F Partner's name, address, city, state, and ZIP code		6b Qualified dividends																									
G <input type="checkbox"/> General partner or LLC member-manager <input type="checkbox"/> Limited partner or other LLC member		7 Royalties																									
H <input type="checkbox"/> Domestic partner <input type="checkbox"/> Foreign partner		8 Net short-term capital gain (loss)																									
I What type of entity is this partner? _____		9a Net long-term capital gain (loss)	17 Alternative minimum tax (AMT) items																								
J Partner's share of profit, loss, and capital (see instructions):		9b Collectibles (28%) gain (loss)																									
<table style="width:100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 30%;"></th> <th style="width: 10%; text-align: center;">Beginning</th> <th style="width: 10%;"></th> <th style="width: 10%; text-align: center;">Ending</th> <th style="width: 10%;"></th> <th style="width: 10%;"></th> </tr> </thead> <tbody> <tr> <td>Profit</td> <td style="text-align: center;">%</td> <td style="border-left: 1px solid black;"></td> <td style="text-align: center;">%</td> <td style="border-left: 1px solid black;"></td> <td style="text-align: center;">%</td> </tr> <tr> <td>Loss</td> <td style="text-align: center;">%</td> <td style="border-left: 1px solid black;"></td> <td style="text-align: center;">%</td> <td style="border-left: 1px solid black;"></td> <td style="text-align: center;">%</td> </tr> <tr> <td>Capital</td> <td style="text-align: center;">%</td> <td style="border-left: 1px solid black;"></td> <td style="text-align: center;">%</td> <td style="border-left: 1px solid black;"></td> <td style="text-align: center;">%</td> </tr> </tbody> </table>		Beginning		Ending			Profit	%		%		%	Loss	%		%		%	Capital	%		%		%		9c Unrecaptured section 1250 gain	
	Beginning		Ending																								
Profit	%		%		%																						
Loss	%		%		%																						
Capital	%		%		%																						
K Partner's share of liabilities at year end:		10 Net section 1231 gain (loss)	18 Tax-exempt income and nondeductible expenses																								
Nonrecourse \$ _____ Qualified nonrecourse financing . . . \$ _____ Recourse \$ _____		11 Other income (loss)																									
L Partner's capital account analysis:		12 Section 179 deduction	19 Distributions																								
Beginning capital account \$ _____ Capital contributed during the year . . \$ _____ Current year increase (decrease) . . \$ _____ Withdrawals & distributions . . . \$ (_____) Ending capital account \$ _____		13 Other deductions	20 Other information																								
<input type="checkbox"/> Tax basis <input type="checkbox"/> GAAP <input type="checkbox"/> Section 704(b) book <input type="checkbox"/> Other (explain) _____		14 Self-employment earnings (loss)																									
M Did the partner contribute property with a built-in gain or loss?		*See attached statement for additional information.																									
<input type="checkbox"/> Yes <input type="checkbox"/> No If "Yes", attach statement (see instructions)		For IRS Use Only																									

This list identifies the codes used on Schedule K-1 for all partners and provides summarized reporting information for partners who file Form 1040. For detailed reporting and filing information, see the separate Partner's Instructions for Schedule K-1 and the instructions for your income tax return.

- 1. Ordinary business income (loss).** Determine whether the income (loss) is passive or nonpassive and enter on your return as follows.
- Report on*
- Passive loss See the Partner's Instructions
 - Passive income Schedule E, line 28, column (g)
 - Nonpassive loss Schedule E, line 28, column (h)
 - Nonpassive income Schedule E, line 28, column (i)
- 2. Net rental real estate income (loss)** See the Partner's Instructions
- 3. Other net rental income (loss)**
- Net income Schedule E, line 28, column (g)
 - Net loss See the Partner's Instructions
- 4. Guaranteed payments** Schedule E, line 28, column (i)
- 5. Interest income** Form 1040, line 8a
- 6a. Ordinary dividends** Form 1040, line 9a
- 6b. Qualified dividends** Form 1040, line 9b
- 7. Royalties** Schedule E, line 4
- 8. Net short-term capital gain (loss)** Schedule D, line 5, column (f)
- 9a. Net long-term capital gain (loss)** Schedule D, line 12, column (f)
- 9b. Collectibles (28%) gain (loss)** 28% Rate Gain Worksheet, line 4 (Schedule D instructions)
- 9c. Unrecaptured section 1250 gain** See the Partner's Instructions
- 10. Net section 1231 gain (loss)** See the Partner's Instructions
- 11. Other income (loss)**
- Code*
- A** Other portfolio income (loss) See the Partner's Instructions
 - B** Involuntary conversions See the Partner's Instructions
 - C** Sec. 1256 contracts & straddles Form 6781, line 1
 - D** Mining exploration costs recapture See Pub. 535
 - E** Cancellation of debt Form 1040, line 21 or Form 982
 - F** Other income (loss) See the Partner's Instructions
- 12. Section 179 deduction** See the Partner's Instructions
- 13. Other deductions**
- A** Cash contributions (50%) } See the Partner's Instructions
 - B** Cash contributions (30%) }
 - C** Noncash contributions (50%) }
 - D** Noncash contributions (30%) }
 - E** Capital gain property to a 50% organization (30%) }
 - F** Capital gain property (20%) }
 - G** Contributions (100%) }
 - H** Investment interest expense Form 4952, line 1
 - I** Deductions—royalty income Schedule E, line 18
 - J** Section 59(e)(2) expenditures See the Partner's Instructions
 - K** Deductions—portfolio (2% floor) Schedule A, line 23
 - L** Deductions—portfolio (other) Schedule A, line 28
 - M** Amounts paid for medical insurance Schedule A, line 1 or Form 1040, line 29
 - N** Educational assistance benefits See the Partner's Instructions
 - O** Dependent care benefits Form 2441, line 12
 - P** Preproductive period expenses See the Partner's Instructions
 - Q** Commercial revitalization deduction from rental real estate activities See Form 8582 instructions
 - R** Pensions and IRAs See the Partner's Instructions
 - S** Reforestation expense deduction See the Partner's Instructions
 - T** Domestic production activities information See Form 8903 instructions
 - U** Qualified production activities income Form 8903, line 7b
 - V** Employer's Form W-2 wages Form 8903, line 17
 - W** Other deductions See the Partner's Instructions
- 14. Self-employment earnings (loss)**
- Note.* If you have a section 179 deduction or any partner-level deductions, see the Partner's Instructions before completing Schedule SE.
- A** Net earnings (loss) from self-employment Schedule SE, Section A or B
 - B** Gross farming or fishing income See the Partner's Instructions
 - C** Gross non-farm income See the Partner's Instructions
- 15. Credits**
- A** Low-income housing credit (section 42(j)(5)) from pre-2008 buildings See the Partner's Instructions
 - B** Low-income housing credit (other) from pre-2008 buildings See the Partner's Instructions
 - C** Low-income housing credit (section 42(j)(5)) from post-2007 buildings Form 8586, line 11
 - D** Low-income housing credit (other) from post-2007 buildings Form 8586, line 11
 - E** Qualified rehabilitation expenditures (rental real estate) } See the Partner's Instructions
 - F** Other rental real estate credits }
 - G** Other rental credits }
 - H** Undistributed capital gains credit Form 1040, line 71; check box a
 - I** Alcohol and cellulosic biofuel fuels credit Form 6478, line 8
 - J** Work opportunity credit Form 5884, line 3

- Code*
- K** Disabled access credit See the Partner's Instructions
 - L** Empowerment zone and renewal community employment credit Form 8844, line 3
 - M** Credit for increasing research activities See the Partner's Instructions
 - N** Credit for employer social security and Medicare taxes Form 8846, line 5
 - O** Backup withholding Form 1040, line 61
 - P** Other credits See the Partner's Instructions
- 16. Foreign transactions**
- A** Name of country or U.S. possession } Form 1116, Part I
 - B** Gross income from all sources }
 - C** Gross income sourced at partner level }
- Foreign gross income sourced at partnership level*
- D** Passive category } Form 1116, Part I
 - E** General category }
 - F** Other }
- Deductions allocated and apportioned at partner level*
- G** Interest expense Form 1116, Part I
 - H** Other Form 1116, Part I
- Deductions allocated and apportioned at partnership level to foreign source income*
- I** Passive category } Form 1116, Part I
 - J** General category }
 - K** Other }
- Other information*
- L** Total foreign taxes paid Form 1116, Part II
 - M** Total foreign taxes accrued Form 1116, Part II
 - N** Reduction in taxes available for credit Form 1116, line 12
 - O** Foreign trading gross receipts Form 8873
 - P** Extraterritorial income exclusion Form 8873
 - Q** Other foreign transactions See the Partner's Instructions
- 17. Alternative minimum tax (AMT) items**
- A** Post-1986 depreciation adjustment } See the Partner's Instructions and the Instructions for Form 6251
 - B** Adjusted gain or loss }
 - C** Depletion (other than oil & gas) }
 - D** Oil, gas, & geothermal—gross income }
 - E** Oil, gas, & geothermal—deductions }
 - F** Other AMT items }
- 18. Tax-exempt income and nondeductible expenses**
- A** Tax-exempt interest income Form 1040, line 8b
 - B** Other tax-exempt income See the Partner's Instructions
 - C** Nondeductible expenses See the Partner's Instructions
- 19. Distributions**
- A** Cash and marketable securities } See the Partner's Instructions
 - B** Distribution subject to section 737 }
 - C** Other property }
- 20. Other information**
- A** Investment income Form 4952, line 4a
 - B** Investment expenses Form 4952, line 5
 - C** Fuel tax credit information Form 4136
 - D** Qualified rehabilitation expenditures (other than rental real estate) See the Partner's Instructions
 - E** Basis of energy property See the Partner's Instructions
 - F** Recapture of low-income housing credit (section 42(j)(5)) Form 8611, line 8
 - G** Recapture of low-income housing credit (other) Form 8611, line 8
 - H** Recapture of investment credit See Form 4255
 - I** Recapture of other credits See the Partner's Instructions
 - J** Look-back interest—completed long-term contracts See Form 8697
 - K** Look-back interest—income forecast method See Form 8866
 - L** Dispositions of property with section 179 deductions } See the Partner's Instructions
 - M** Recapture of section 179 deduction }
 - N** Interest expense for corporate partners }
 - O** Section 453(j)(3) information }
 - P** Section 453A(c) information }
 - Q** Section 1260(b) information }
 - R** Interest allocable to production expenditures }
 - S** CCF nonqualified withdrawals }
 - T** Depletion information—oil and gas }
 - U** Amortization of reforestation costs }
 - V** Unrelated business taxable income }
 - W** Precontribution gain (loss) }
 - X** Section 108(j) information }
 - Y** Other information }

CHAPTER 4 – REVIEW QUESTIONS

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Which of the following is not true regarding a limited partnership:
 - a) a limited partnership is formed under state law
 - b) a limited partnership has at least one general partner
 - c) a limited partnership has at least two limited partners
 - d) a limited partnership has at least one partner who is liable for the debts of the partnership

2. The maximum penalty a partnership can be assessed for not filing a partnership return on time is \$195.
 - a) true
 - b) false

3. Generally, an accrual basis taxpayer can deduct accrued expenses in the tax year in which:
 - a) all events that determine the liability have occurred
 - b) the amount of the liability can be figured with reasonable accuracy
 - c) economic performance takes place with respect to the expense
 - d) all of the above are true

4. If there is no majority interest tax year, the partnership must use the tax year of all its principal partners.
 - a) true
 - b) false

5. Which of the following is not included in portfolio income:
 - a) income derived in the ordinary course of a trade or business
 - b) dividends
 - c) royalties
 - d) income from the disposition of property held for investment

6. The costs required to be capitalized under section 263A are not deductible until the property to which the costs relate is sold, used, or otherwise disposed of by the partnership.
- a) true
 - b) false
7. Business start-up and organizational expenses incurred after December 31, 2009:
- a) must be amortized regardless of amount
 - b) can be deducted up to \$60,000
 - c) can be deducted up to \$10,000 if the total of these costs does not exceed \$60,000
 - d) are treated the same as syndication costs
8. Which of the following should be included on line 11 of Form 1065:
- a) cost of a new building
 - b) cost of permanent improvements to property
 - c) cost of incidental repairs that do not add to the value of the property
 - d) all of the above
9. Both the total debts that became worthless in whole or in part during the year related to a trade or business activity should be entered on line 12, Bad Debts.
- a) true
 - b) false
10. Items that must be reported separately on Schedules K and K-1 cannot be deducted on line 20 of Form 1065.
- a) true
 - b) false
11. Small partnerships are:
- a) defined as having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner
 - b) required to follow the rules for consolidated audit proceedings
 - c) may revoke the Election of Partnership Level Tax Treatment without IRS consent
 - d) all of the above
12. If a partnership does not distribute the partnership income, the partner does not have to include their share of the income on their individual return.
- a) true
 - b) false

13. Schedule K-1:
- a) should be prepared for each person who was a partner during the year
 - b) should be provided to each partner within 30 days of the end of the partnership year
 - c) should be provided jointly to a husband and wife if they both had an interest in the partnership
 - d) is prepared for the partnership in total
14. Partnerships are not allowed a deduction for any contribution of \$250 or more.
- a) true
 - b) false
15. The Schedule K-1 should be filed with the partner's tax return.
- a) true
 - b) false
16. A partner who sells or exchanges a partnership interest in a section 751(a) exchange must notify the partnership, in writing, within 30 days of the exchange (or, if earlier, by January 15 of the calendar year following the calendar year in which the exchange occurred).
- a) true
 - b) false
17. Any partnership losses that a partner cannot deduct on his or her own return:
- a) are lost forever
 - b) may be carried forward indefinitely
 - c) may be carried back 2 years and forward 5 years
 - d) may only be carried forward 2 years

CHAPTER 4 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Limited partnerships are regulated by state law.
B: Incorrect. There must be at least one general partner in a limited partnership.
C: Correct. There only needs to be one limited partner, not two or more.
D: Incorrect. The requirement of one general partner covers this requirement.

(See page 4-3 of the course material.)

2. A: True is incorrect. The penalty for not filing a partnership return on time, including extensions, is \$195 times the total number of partners in the partnership during any part of the tax year for each month the return is late, up to twelve months.

B: False is correct. The penalty assessed for not filing a partnership return on time is \$195 times the total number of partners in the partnership during any part of the tax year for each month the return is late, up to twelve months. The penalty will not be imposed if the partnership can show reasonable cause for its failure to file a timely return.

(See page 4-4 of the course material.)

3. A: Incorrect. This is one necessary factor, but other factors must also be true.
B: Incorrect. This is one necessary factor, but other factors must also be true.
C: Incorrect. This is one necessary factor, but other factors must also be true.

D: Correct. All of these factors must be true to deduct accrued expenses in the tax year.

(See page 4-5 of the course material.)

4. **A: True is correct.** A principal partner is one who has a 5% or more interest in the profits or capital of the partnership.

B: False is incorrect. If there is no majority interest tax year and the principal partners do not have the same tax year, the partnership generally must use a tax year that results in the least aggregate deferral of income to the partners.

(See page 4-7 of the course material.)

5. **A: Correct.** This income is considered income from trade or business activities.
- B: Incorrect. Dividend income is a subset of portfolio income.
- C: Incorrect. Royalty income is a part of the total portfolio income.
- D: Incorrect. Income from the disposition of property held for investment is included in portfolio income.

(See page 4-11 of the course material.)

6. **A: True is correct.** The uniform capitalization rules of section 263A require partnerships to capitalize or include in inventory costs, certain costs incurred in connection with the production of real and tangible personal property held in inventory or held for sale in the ordinary course of business, real property or personal property acquired for resale, and the production of real property and tangible personal property by a partnership for use in its trade or business or in an activity engaged in for profit.

B: False is incorrect. Partnerships subject to the uniform capitalization rules are required to capitalize not only direct costs but an allocable part of most indirect costs that benefit the assets produced or acquired for resale, or are incurred by reason of the performance of production or resale activities.

(See page 4-17 of the course material.)

7. A: Incorrect. Under certain circumstances, a portion of the business start-up and organizational expenses may be deductible.
- B: Incorrect. The limit for deducting business start-up and organizational expenses is less than \$60,000.
- C: Correct.** The \$10,000 deduction is reduced (but not below zero) by the amount the total exceeds \$60,000.
- D: Incorrect. Syndication costs must be capitalized. They cannot be depreciated or amortized.

(See pages 4-18 to 4-19 of the course material.)

8. **A:** Incorrect. The costs of a new building are not deductible. These costs are chargeable to capital accounts and may be depreciated or amortized.

B: Incorrect. The costs of permanent improvements to property are not deductible. These costs are chargeable to capital accounts and may be depreciated or amortized.

C: Correct. These costs are only deductible if they relate to a trade or business and are not claimed elsewhere on the return.

D: Incorrect. Only one of the responses is correct. Therefore, “all of the above” cannot be correct.

(See page 4-20 of the course material.)

9. **A: True is correct.** Cash method partnerships cannot take a bad debt deduction unless the amount was previously included in income.

B: False is incorrect. Deductible nonbusiness bad debts should be reported as a short-term capital loss on Schedule D (Form 1065).

(See page 4-20 of the course material.)

10. **A: True is correct.** Other items that cannot be deducted on line 20 are net operating losses and expenses paid or incurred to influence federal or state legislation, or to influence the actions or positions of certain federal executive branch officials.

B: False is incorrect. Line 20 should include the total allowable trade or business deductions that are not deductible elsewhere on page 1 of Form 1065. Items that should be included on this line are amortization, insurance premiums, legal and professional fees, and supplies used and consumed in the business.

(See page 4-25 of the course material.)

11. **A: Correct.** The small partnership exception does not apply if any partner during the tax year is a partnership, estate, trust, S corporation, nominee, or disregarded entity.

B: Incorrect. Small partnerships are not subject to the rules for consolidated audit proceedings, but may elect to be subject to these rules by attaching Form 8893 or an election statement to the partnership return for the first taxable year for which the election is to be effective.

C: Incorrect. Once the election for partnership level tax treatment has been made, it cannot be revoked without IRS consent.

D: Incorrect. Only one of the responses is correct. Therefore, “all of the above” cannot be correct.

(See page 4-31 of the course material.)

12. A: True is incorrect. Although the partnership is not subject to income tax, the partners are liable for tax on their shares of the partnership income, whether or not distributed, and must include their shares on their tax returns.

B: False is correct. The partners must include their shares of the partnership income on their tax returns whether or not the income was distributed. Schedule K-1 shows each partner's separate share.

(See page 4-35 of the course material.)

13. **A: Correct.** Any person who holds an interest in a partnership as a nominee for another person must furnish the partnership the name, address, etc., of the other person.

B: Incorrect. The Schedule K-1 must be provided to each partner on or before the day on which the partnership return is required to be filed.

C: Incorrect. If a husband and wife both have an interest in the partnership, a separate Schedule K-1 should be prepared for each of them.

D: Incorrect. Schedule K is a summary schedule of all the partners' shares of the partnership's income, credits, deductions, etc. The Schedule K-1 is prepared for each partner's separate share.

(See pages 4-36 to 4-37 of the course material.)

14. A: True is incorrect. The partnership can generally deduct a contribution of \$250 or more if they obtain a written acknowledgment from the charitable organization that shows the amount of cash contributed, describes any property contributed, and gives an estimate of the value of any goods or services provided in return for the contribution.

B: False is correct. Generally, the contribution can be deducted by the partnership if the partnership receives a written acknowledgment of the gift before the due date of the return, including extensions. The acknowledgment letter should not be included with the return, but should be kept with the partnership's records.

(See page 4-50 of the course material.)

15. True is incorrect. The Schedule K-1 is used by the partnership to report the partner's share of the partnership's income, deductions, credits, etc. It should be kept with the partner's records, but not included with the partner's return.

B: False is correct. The partnership files a copy of the Schedule K-1 with the IRS, but the partner should not.

(See page 4-89 of the course material.)

16. **A: True is correct.** A “section 751(a) exchange” is any sale or exchange of a partnership interest in which any money or other property received by the partner in exchange for that partner’s interest is attributable to unrealized receivables (as defined in section 751(c) or inventory items (as defined in section 751(d)).

B: False is incorrect. The written notice to the partnership must include the names and addresses of both parties to the exchange, the identifying numbers of the transferor and (if known) of the transferee, and the exchange date.

(See page 4-89 of the course material.)

17. A: Incorrect. There are carry forward rules.

B: Correct. These losses can be deducted in a later year subject to the basis limit for that year

C: Incorrect. These losses can be carried forward, but not back.

D: Incorrect. The carry forward period is not limited to 2 years.

(See page 4-91 of the course material.)

Glossary

At-risk Limits – The at-risk rules limit your losses from most activities to your amount at risk in the activity.

Below-market Loan – A loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate.

Capital Interest – An interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in a complete liquidation of the partnership.

Electronic Federal Tax Payment System (EFTPS) – An electronic federal tax payment system developed by the U.S. Treasury for corporations to report and pay Federal Tax Deposits.

General Partner – A partner who is personally liable for partnership debts.

General Partnership – A partnership composed only of general partners.

Guaranteed Payments – Payments made by a partnership to a partner that are determined without regard to the partnership's income.

Installment Sale – A sale in which you receive the proceeds over a period of time. You recognize any gain on an installment sale as you receive the selling price, not including interest. Proceeds are received in more than one tax year.

Limited Partner – A partner whose personal liability for partnership debts is limited to the amount of money or other property that the partner contributed or is required to contribute to the partnership.

Limited Partnership – A partnership formed under a state limited partnership law and composed of at least one general partner and one or more limited partners.

Organizational Costs – The direct costs of creating the corporation.

Partnership – The relationship between two or more persons who join to carry on a trade or business, with each person contributing money, property, labor or skill, and each expecting to share in the profits and losses of the business whether or not a formal partnership agreement is made.

Passive Activity Limits – Generally limit your losses from passive activities to your passive activity income.

Profits Interest – A partnership interest other than a capital interest.

Start-up Costs – Costs incurred for creating an active trade or business or for investigating the creation or acquisition of an active trade or business.

Tax Matters Partner (TMP) – The TMP of any partnership is: (A) the general partner designated as the tax matters partner, or (B) if there is no general partner who has been so designated, the general partner having the largest profits interest in the partnership. If no general partner has been designated as the TMP and the Secretary determines that it is impracticable to apply the largest profits interest rule, the partner selected by the Secretary shall be treated as the tax matters partner.

Trust Fund Recovery Penalty – To encourage prompt payment of withheld and other collected payroll taxes by allowing the Internal Revenue Service to assert a liability against responsible third parties [IRC 6672]. The amount of the penalty imposed by the statute for failure to comply with its provisions is measured by the payroll taxes required to be collected or collected and not paid over. That is why the liability is referred to as a "100% Penalty." The penalty is civil in nature, not criminal.

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