Strafford

Federal Schedule K-1 Issues for Tax Return Preparers

Addressing Complex Compliance Issues With Basis, Gains and Losses

THURSDY, May 30, 2013, 1:00-2:50 pm Eastern

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Federal Schedule K-1 Issues for Tax Return Preparers Seminar

May 30, 2013

Carolyn Turnbull, McGladrey LLP
turnbullcarolyn@aol.com

Gregory Levy, Kaufman Rossin
glevy@kaufmanrossin.com

Anne Bushman, McGladrey LLP
anne.bushman@mcgladrey.com

Today's Program

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INFORMATION ABOUT THE PARTNER

Information About The Partner

E	Partner's identifying number

- Item E: Partner's identifying number
  - For individual, use SSN or ITIN
  - For others, use EIN
  - For IRA, use identifying number of the custodian of the IRA, not the SSN of the person for whom the IRA is maintained
  - For a DRE, use the owner's identifying number; enter the owner's name and address in Item F

Information About The Partner (Cont.)

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

- Item G: Is the partner a general or limited partner?
  - If a partner owns 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.

Information About The Partner (Cont.)

H ☐ Domestic partner ☐ Foreign partner

- Item H: Is the partner a domestic or foreign partner?
  - The partner is a foreign partner if a:
    - Non-resident alien individual,
    - Foreign partnership,
    - Foreign corporation,
    - Foreign estate, or
    - Foreign trust.

Information About The Partner (Cont.)

I What type of entity is this partner?

- Item I: Type of entity
  - State whether the partner is:
    - An individual
    - A corporation
    - An estate
    - A trust
    - A disregarded entity (DE)
    - An exempt organization
    - A foreign government
    - A nominee (custodian)
  - If an LLC other than a DE, enter the LLC's federal income tax classification
  - If a nominee, enter one of the following codes after "nominee" *(see next slide):*

Information About The Partner (Cont.)

I1 What type of entity is this partner? (see instructions)

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

- Item I: Type of entity (Cont.)
  - If a nominee, enter one of the following codes after "nominee":
    - I – individual
    - C – corporation
    - F – estate or trust
    - P – partnership
    - DE – disregarded entity
    - E – exempt organization
    - IRA – individual retirement account
    - FGOV – foreign government
- Note new item I2 on the draft 2012 Schedule K-1 (Form 1065)

Information About The Partner (Cont.)

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

- Item K: Partner's share of liabilities at year-end
  - Non-recourse financing
    - Liabilities for which <u>no</u> partner bears the economic risk of loss
      - See Reg. §1.752-2 to determine extent to which a partner bears the economic risk of loss
      - Do not include partner's share of partnership-level, qualified, non-recourse financing
      - General rule is to enter the partner's share of non-recourse liabilities at the end of the year.
        - If partner terminated its interest during the year, enter the partner's share of non-recourse liabilities immediately before the total disposition.

Information About The Partner (Cont.)

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

- Item K: Partner's share of liabilities at year-end (Cont.)
  - Qualified non-recourse financing
    - Secured by real property used in an activity of holding real property that is subject to the at-risk rules under 465
    - Borrowings used in an activity of holding real property
    - No one is personally liable for the debt.
    - Borrowed from, or guaranteed by, a federal, state or local government or instrumentality thereof, or a "qualified person"
    - Not convertible into stock or securities

Information About The Partner (Cont.)

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

- Item K: Partner's share of liabilities at year-end (Cont.)
  - Qualified non-recourse financing
    - "Qualified person" is a lender in the business of lending money and who has no interest in the activity in which the funds are used.
    - Qualified person is not:
      - A related person, unless the non-recourse 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.

Information About The Partner (Cont.)

K Partner's share of liabilities at year end:

Nonrecourse	$	
Qualified nonrecourse financing .	$	
Recourse	$	

- Item K: Partner's share of liabilities at year-end (Cont.)
  - Other recourse financing
    - Liabilities for which one or more partners bear economic risk of loss
    - Determined using rules under §752
  - Other information required to be attached to Schedule K-1
    - Information for a partner to determine its share of the partnership's non-recourse, partnership-level qualified non-recourse, and other recourse liabilities allocable to each at-risk activity and any other activity, if applicable
    - Information a partner needs to determine if qualified non-recourse financing rules are also met at the partner level (e.g., related-party information)

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PARTNER'S SHARE OF CURRENT-YEAR INCOME, DEDUCTIONS, CREDITS AND OTHER ITEMS

Partner’s Share Of Current-Year Income, Deductions, Credits And Other Items

- Line 1: Ordinary business income (loss)
  - Use to report the partner’s distributive share of ordinary business income or loss
  - Do not include special allocations on line 1
    - Instead, enter special allocations of ordinary income on line 11 of Schedule K-1 Item M
    - For special allocation of other items, enter the amount on the applicable line of Schedule K-1 (for example, a special allocation of depreciation expense under 734(b) or 743(b) would be entered on Schedule K-1, line 13)
  - If the partnership has more than one trade or business activity, identify on a separate statement (for each activity) the amounts reported on each line of Part III of the Schedule K-1.
  - Pay attention to the grouping rules for passive activities

Partner's Share Of Current-Year Income, Deductions, Credits And Other Items (Cont.)

- Line 3: Other net rental income (loss)
  - Use to report gross income and deductible expenses from rental activities other than those reported on Form 8825
    - Note that Schedule K requires gross rental income (loss), expenses and other net rental income (loss) to be reported separately. These amounts are reported as one line item on line 3 of the Schedule K-1.
  - Include gain (loss) from line 17 of Form 4797 attributable to asset used in a rental activity other than a rental real estate activity.
  - Attach a schedule for each activity, if the partnership has more rental activity
  - An activity is a rental activity for a tax year if:
    - Tangible property held in connection with the activity is used by customers, or held for use by customers; and
    - The gross income from the activity represents amounts paid, or to be paid, principally for the use of such property.

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Partner's Share Of Current-Year Income, Deductions, Credits And Other Items (Cont.)

- Activities not treated as a rental activity (Reg. 1.469-1T(e)(3)(ii))
  - Average period of customer use is 7 days or fewer
  - Average period of customer use is 30 days or fewer, and significant personal services are provided
  - Extraordinary personal services are provided (even if the average period of customer use is greater than 30 days)
  - Rentals are incidental to non-rental activities
  - Property is made available to customers during defined hours of business for their non-exclusive use
  - Partnership provides property to a joint venture or partnership in which the partnership holds an interest, and the property is provided in the partnership's capacity as an owner of such an interest rather than rented to the joint venture or partnership

Partner's Share Of Current-Year Income, Deductions, Credits And Other Items (Cont.)

- Line 2: Net rental real estate income (loss)
  - Use to report the partner's distributive share of net rental real estate income or loss from Form 8825
  - If the partnership has more than one rental real estate activity, identify on a separate statement the amount of income or loss attributable to each activity.
  - Attach a statement identifying net income (loss) and the partner's share of the partnership's 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 the residence is rented at fair rental value
  - Do not report short-term real estate rentals (i.e., rentals where average period of customer use is 7 days or fewer) on this line
  - Note: Amounts reported on this line may be included in net earnings (loss) from self-employment on line 14 of the Schedule K-1.

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Partner's Share Of Current-Year Income, Deductions, Credits And Other Items (Cont.)

- Line 4: Guaranteed payments
  - Use to report payments made to a partner that are determined without regard to the partnership's income
  - Guaranteed payments include:
    - Payments for salaries, health insurance, and interest deducted by the partnership and reported on:
      - Page 1, line 10 of Form 1065;
      - Form 8825; or
      - Schedule K, line 3b.
    - Compensation deferred under a 409A non-qualified deferred compensation plan that does not meet the requirements of 409A reported on line 20c (Code Y) of Schedule K
    - Payments required to be capitalized (e.g., 263A)

Partner's Share Of Current-Year Income, Deductions, Credits And Other Items (Cont.)

- Line 4: Guaranteed payments
  - Guaranteed payments are <u>not</u> considered passive income.
  - Property distributed to a partner as part or all of a guaranteed payment is treated as a sale or exchange of the property by the partnership.

New §1411 3.8% on Net Investment Income

Background

- Sec. 1411(a) imposes a 3.8% tax on the lesser of an individual’s:
  - Net investment income, or
  - The excess (if any) of –
    - Modified adjusted gross income (MAGI) over
    - A threshold amount.
- Threshold amount
  - $250,000 for taxpayers filing a joint return or surviving spouses
  - $125,000 for married taxpayers filing separately
  - $200,000 for other taxpayers

New §1411 3.8% on Net Investment Income

Background – cont.

- For estates and trusts, §1411(a)(2) imposes a 3.8% tax on the lesser of:
  - Undistributed net investment income, or
  - The excess (if any) of –
    - Adjusted gross income, over
    - The dollar amount at which the highest tax bracket in which §1(e) begins for the year.

New §1411 3.8% on Net Investment Income

Background – cont.

- Sec. 1411(c) defines "net investment income" as the excess (if any) of:
  - The sum of –
    - Gross income from interest, dividends, annuities, royalties, and rents, *other than such income which is derived in the ordinary course of a trade or business* (emphasis added) described in §1411(c)(2),
    - Other gross income derived from a trade or business described in §1411(c)(2), and
    - Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in §1411(c)(2), over
  - The deductions allowed by Subtitle A of the Internal Revenue Code that are properly allocable to such gross income or net gain.

New §1411 3.8% on Net Investment Income

Background – cont.

- A trade or business is described in §1411(c)(2) if the trade or business is:
  - A passive activity with respect to the taxpayer, or
  - A trade or business of trading in financial instruments or commodities Background – cont.

New §1411 3.8% on Net Investment Income

Background – cont.

- Disposition of an interest in an S corporation or partnership (”pass-thru entity”)
  - Sec. 1411 (c)(4) provides that gain (or loss) from the disposition of an interest in a pass-thru entity is taken into account under §1411(c)(1)(A)(iii) only to the extent of the net gain (or net loss) which would be so taken into account by the transferor if all property of the pass-thru entity were sold for FMV immediately before the disposition of such interest.
- Sec. 1411(c)(6) provides that §1411 does not include any item taken into account in determining self-employment income.

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OWNERSHIP PERCENTAGES

Partner Percentages: Timing

Tax year OR immediately after admission

Tax year OR immediately before interest terminates

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

	Beginning	Ending
Profit	%	%
Loss	%	%
Capital	%	%

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Partner Percentages: Computations

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

	Beginning		Ending
Profit	~~"Various"~~	%	%
Loss	~~"Per Agreement"~~	%	%
Capital	~~Neg./Blank~~	%	%

- Per agreement, OR reasonable and consistent
- Add to 100%, EXCLUDING timing differences
- Or, zero for all partners when appropriate

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CAPITAL ACCOUNTS

Capital Accounts

L Partner's capital account analysis:

Beginning capital account	$	
Capital contributed during the year	$	
Current year increase (decrease) .	$	
Withdrawals & distributions . .	$	( )
Ending capital account	$	

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

- Not required if answered "yes" to question 6 of Schedule B
- Total of amounts of all partners' K-1s should equal Sch M-2
- Method used to compute the amounts in Schedule M-2 and Item L on the K-1s need not agree with the method of accounting used to report amounts on Schedule L.
  - Attach a statement to reconcile any differences

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Capital Accounts (Cont.)

L Partner's capital account analysis:

Beginning capital account	$	
Capital contributed during the year	$	
Current year increase (decrease) .	$	
Withdrawals & distributions . .	$	( )
Ending capital account	$	

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

☐ Other (explain)

- Tax basis means the method of accounting is based on partnership's income and deductions, for tax purposes.
- Sect. 704(b) book means the capital account is based on the capital accounting rules under Reg. 1.704-1(b)(2)(iv).
- Withdrawals and distributions may not agree with the amount reported on line19 of the Schedule K-1.

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Certain Contributions

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

☐ **Yes** ☐ **No**

If "Yes," attach statement (see instructions)

- If "yes," attach a statement containing the following information:
  - Description of each property the partner contributed,
  - Date the property was contributed,
  - Amount of the property's gain or loss, and
  - Partner's capital account analysis.
- Partnership is not required to report information on a separate-property basis, if a partner contributes more than 10 properties with a built-in gain or loss on any day during the taxable year.
  - Partnership may instead report totals

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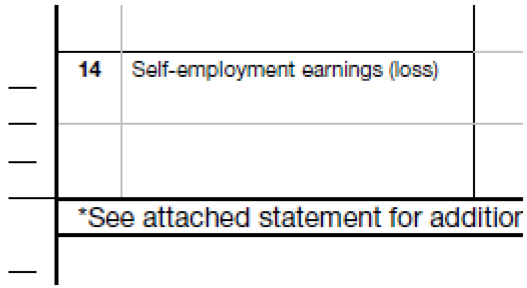
SELF-EMPLOYMENT TAXES

Self-Employment Earnings, In General

- To complete or not to complete



14	Self-employment earnings (loss)

*See attached statement for additior

- Depends on partner type
  - Estate, trust, corporation, exempt org, IRA – no SE
  - General partner – all SE
  - Limited partner – only guaranteed payments for services

Self-Employment Earnings: Computation

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	

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Self-Employment Earnings: Other Issues

- What about other partnership types that do not have conventional general partner and limited partners?

  - Sect.1402(a)(13) excludes limited partners, EXCEPT for guaranteed payments.

  - 1997 proposed regulations excluded certain partners from limited partner exceptions, so that they could be subject to SE on more than guaranteed payments.
    - IRS has stated that taxpayers can rely on proposed regulations.

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Self-Employment Earnings: Other Issues (Cont.)

- What about other partnership types that do not have conventional general partner and limited partners?

  - Passive activity cases – LLC members, not limited partners
    - New proposed regulations for Sect. 469, but not for Sect. 1402

  - *Renkemeyer, Campbell & Weaver LLP et al.*, 136 TC No 7, Dec. 58,543 (Feb. 9, 2011)
    - Lawyers in LLP were subject to SE on entire portion, because they actively participated.

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ELECTRONIC K-1s

Providing K-1s To Partners

- Partnerships required to submit “written statement” to partners
- Rev. Proc. 2012-17 provides requirements for sending electronically.
  - Affirmative consent from recipient demonstrating it can access K-1 in same format
  - Provisions for withdrawal/hardware/software
  - Disclosures describing consent, or lack thereof
    - Scope
    - Duration

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Electronic K-1 Reminders

- Only applies if no paper K-1 sent
- Statute and potential penalty at partnership level
- Review disclosures each year
  - Software/hardware changes
  - Duration
  - New partners

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K-1 ATTACHMENTS

Supplements To K-1

- Be cautious of additional information required
- Following lists are NOT all-inclusive
- General categories
  - Transactions between partners and partnership
  - Transactions between partners
- In general, details provided in regulations

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Supplements To K-1 (Cont.)

FORM/STATEMENT	PURPOSE
Sect. 732(d) statement	Basis adj. for distributed property
Sect. 108(b)(5) statement	Basis adj. related to debt discharge
Sect. 754 election	To adjust basis in certain instances
Sect. 743 statement	Basis adj. when transfer of interest
Sect. 708 statement	Continuation of partnership after merger or division
Sect. 707 statement	Disguised sale disclosure
Sect. 751 statement	Notice of 751(a) exchange or sale of interest with 751 property
Sect. 734 statement	Basis adj. when partner distribution
Sect. 736 statement	Pro-rate recovery of partner basis during liquidation

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Supplements To K-1 (Cont.)

FORM/STATEMENT	PURPOSE
Sect. 706 statement	Show tax year based on least aggregate deferral method
Sect. 6231 statement	Elect TEFRA treatment
Notice 89-35 statement	Debt-financed distributions
Sect. 469 statement	Self-charged interest rules
Sect. 469 statement	Group certain activities
Sections 1445/1446 statements	Foreign partner withholding
Form 8308	Sale or exchange of certain partnership interests
Form 8804	Annual return for partnership withholding tax under Sect. 1446
Form 8805	Foreign partner's information statement of Sect. 1446 withholding

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K-1 LESSONS FROM HEDGE FUND, FUND OF FUNDS COMPLIANCE

Trader vs. Investor In General:

- A hedge fund is either engaged in the TRADE or BUSINESS of trading securities or it is an INVESTOR in securities

- Another form of a hedge fund is what is known as a Fund of Funds, which is a fund that invests in other hedge funds and often has qualities of each type of fund.

Investor Funds

- Funds that buy securities with the intention of holding them for their long-term appreciation and/or interest or dividends are considered investors.

- Signs of an investor fund:
  - Long-Term Capital Gain (realized or unrealized)
  - Dividend Income
  - Partnership agreement indicating gain from the long-term holding of securities is an investment strategy.

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Investors

- Investors' long-term gains are currently taxed at a 15% rate; net long-term and short-term losses generally are limited to $3,000 per year.

- Investment expenses are deductible on schedule A, subject to a 2%-of-adjusted-gross-income limit; any such deductions are added back to income for alternative minimum tax (AMT) purposes.

- Any margin interest paid on investments is currently deductible only to the extent of investment income.

Investors K-1

- Presentation on Schedule K-1 is straight forward.
- Ordinary income items presented as portfolio income and portfolio deductions.
- Allocations of capital gains follow Regulations under 704(c), or use layering methodology.

Trader Funds

- To qualify as a trader, there are no fixed requirements in the tax code. The taxpayer must trade in stocks, securities, futures, contracts, or options on a relatively short-term basis.

- Tax preparers make observations about a fund's trading style and make a determination based upon existing court cases relating to trading activity.

- The determination is done yearly, and the fund may be a trader in one year and not in another. This is not a change in accounting method, so it is relatively easy for the fund to switch back and forth on the designation.

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Passive vs. Non-passive

- Hedge Funds: passive or non-passive?

  – Per Regulation 1.469-1T(E)(6)(i)
    - In general. An activity of trading personal property for the account of owners of interests in the activity is not a passive activity (without regard to whether such activity is a trade or business activity).
    - When encountering a trader fund, a footnote stating this should appear on the K-1.

Traders – Tax Advantage

- Expenses incurred are deductible without the 2% limit applicable to investors
- These expenses are not added back for AMT purposes.
- Margin interest associated with the trading activity is fully deductible for the General partner; however is subject the investment interest limitations on Form 4952 for all other LP's. The expense is taken on Schedule E, subject to the limitation.
- Expenses incurred by a trader reduce his or her adjusted gross income for purposes of phasing out itemized deductions (note that phase-out is not applicable for the years 2010 and 2011 under the 2010 Tax Relief Act).
- A trader's activity is not subject to self-employment tax.

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Trader K-1

- Presentation of the expenses vary by firm. They may be shown on Line 11, Line 13 or Line 1.
- The footnotes to the K-1 should explain how investors can claim these expenses
- Allocations of capital gains follow Regulations under 704(c), or use layering methodology.

Trader vs. Investor

Ordinary income	X	X
Dividend Income	X	X
Interest Income	X	X
STCG	X	X
LTCG	X	X
Interest Expense	**Schedule E**	**Schedule A**
Deductions	**Schedule E**	**Schedule A**

Interest expense deductions for limited partners are subject to limitations for both traders and investors; and for the general partner of an investor.

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K-1 Income Allocations – Ordinary items

- Ordinary income items are generally allocated by a method that resembles ownership for the year. Ideally, ordinary income items are allocated as they are earned, by ownership percentage, to each partner. Absent sufficient information to drill down to that detail, many preparers will allocate ordinary items by weighted ownership percentage. In a fund of funds environment, weighted ownership percentage may be the only choice for ordinary income items.

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K-1 Income Allocations – Capital Gains

- Several different methodologies can be used to allocate capital gains in an investment partnership. The most common methods are described in the Regulations for IRC Section 704(c), and are known as full-netting and partial-netting. Another method that can be used is known as layering, which tends to be cumbersome and is not used as often in this environment.

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K-1 Income Allocations – Full-Netting

	Tax	Unrealized	Book
	Basis	Gain	Basis
A	100,000	25,000	125,000
B	100,000	25,000	125,000
	200,000	50,000	250,000
	Original	Increase	FMV of
	Investment	in Value	Investment
NOK	100,000	20,000	120,000
SGP	100,000	30,000	130,000
	200,000	50,000	250,000

A and B form a partnership with each contributing $100,000. The partnership buys two stocks. During the course of the year those stocks go up in value so that each partner has a book capital account of $125,000.

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K-1 Income Allocations – Full-Netting

	Tax Basis	Unrealized Gain	Book Basis
A	100,000	35,000	135,000
B	100,000	35,000	135,000
C	125,000	10,000	135,000
	325,000	80,000	405,000
	Original Investment	Increase in Value	FMV of Investment
NOK	100,000	20,000	120,000
SGP	100,000	30,000	130,000
IBM	125,000	30,000	155,000
	325,000	80,000	405,000

Partner C enters in the next period, and contributes $125,000, so all three partners have the same book capital accounts. Additional stock is purchased, and book value goes up another $30,000.

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K-1 Income Allocations – Full-Netting

	Tax	Unrealized	Book
	Basis	Gain	Basis
A	100,000	35,000	135,000
B	100,000	35,000	135,000
C	125,000	10,000	135,000
	325,000	80,000	405,000
	Original	Increase	FMV of
	Investment	in Value	Investment
NOK	100,000	20,000	120,000
SGP	100,000	30,000	130,000
IBM	125,000	30,000	155,000
	325,000	80,000	405,000

The partners decide to sell SGP at this point, which has an unrealized gain of $30,000 – when sold this becomes taxable income. What is the most logical way to allocate the $30,000 gain between the three partners?

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K-1 Income Allocations – Full-Netting

	Unrealized	Realized	Remaining
	Gain	Gain	Unrealized
A	35,000	13,125	21,875
B	35,000	13,125	21,875
C	10,000	3,750	6,250
	80,000	30,000	50,000

The most logical way to allocate the gain is by the amounts of unrealized gain each partner has. This is the basis of the full-netting concept, and it is identified in Regulation 1.704-3.

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K-1 Income Allocations – Partial Netting

	Tax	Unrealized	Book
	Basis	Gain	Basis
A	100,000	30,000	130,000
B	100,000	30,000	130,000
C	125,000	5,000	130,000
D	135,000	(5,000)	130,000
	460,000	60,000	520,000

Partial-netting is very similar to full-netting. The difference is the gains and losses are allocated separately. This method may reduce disparities faster than full-netting can.

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K-1 Income Allocations – Partial Netting

	Unrealized Gain	Allocation	Remaining Unrealized
A	30,000	15,692	14,308
B	30,000	15,692	14,308
C	5,000	2,616	2,384
D	(5,000)	(4,000)	(1,000)
	60,000	30,000	30,000

Assume we are allocating $30,000 in realized gains again, but that amount is composed of $34,000 of gain and $4,000 of loss. Loss is first allocated to the partner with unrealized losses, gains are allocated to the partners with unrealized gains.

K-1 Income Allocations – Layering

	Period 1	Period 2	Period 3
Partner A	0.5	0.3333	0.25
Partner B	0.5	0.3333	0.25
Partner C		0.3333	0.25
Partner D			0.25

Stock A	20,000		14,000
Stock B	30,000		-
Stock C		30,000	(34,000)

Sell Stocks A and C

				Total Gain
Partner A	10,000	9,999	(5,000)	14,999
Partner B	10,000	9,999	(5,000)	14,999
Partner C	-	9,999	(5,000)	4,999
Partner D	-	-	(5,000)	(5,000)

Layering is the most precise method, but also the most cumbersome. The period appreciation or depreciation of each stock lot must be tracked simultaneously with each partner's ownership percentage for each period. When the stocks are sold, each partner receives their exact portion of appreciation or depreciation for each stock.

This method is not commonly used due to the amount of record keeping necessary.

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Allocation Methods

- 90% Threshold
  - Funds that have investments where over 10% of the assets are not qualified do not have basis to use the aggregate method.
  - Layering method is the alternative
    - Costly and time consuming
  - A number of funds choose to use aggregate with disclosure when they don't meet the qualifications for using the aggregate method.
    - Some funds use aggregate when not qualified and don't disclose.

Allocation Methods

- 90% Threshold – Investments that don’t meet the definition of qualified financial assets and can keep a fund from meeting the criteria to use the aggregate method:
  - Real estate partnerships (including PTPs)
  - Trade claims
  - Private equity
  - Loans (origination or lending activities)
  - Consumer receivables

Allocation Methods

- Fill-up/Fill-down Provisions
  - Standard industry practice
  - Effective means of keeping partners who remain in the partnership from being taxed on a withdrawing partner's gain or losses.
  - Redirects realized gains/losses from the sale of securities within the partnership to the withdrawing partner so that book and tax basis are equalized
  - Withdrawing partner still has same total amount of realized gain/loss and the remaining partners defer recognition of redirected gains/losses; however, the mix between long-term and short-term of a withdrawing partner may differ when stuffed.
  - Potentially helps to eliminate significant inside/outside basis issues and can obviate the need for ***Mandatory Basis Adjustments***

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Other Issues – Form 8886

- Section 988
  - Per Reg 1.6011-4, a single Section 988 loss of at least $50,000 that flows to an individual or trust is a reportable transaction.
  - Many, if not most, K-1s do not provide the user with a breakdown of the individual transactions, but provide a generic comment that they engaged in Section 988 transactions.
- Loss transactions
  - Threshold of $2,000,000 for a single year for partnerships and individuals/ $4,000,000 for a series of years.
    - Consider losses on offshore corporations – don't meet exception criteria.

Common Filing Requirements Resulting From Foreign Investments

- **Form 926** - Return by a U.S. Transferor of Property to a Foreign Corporation

- **Form 8865** - Return of U.S. Persons With Respect to Certain Foreign Partnerships

- **Form 8621** – Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund

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Common Filing Requirements Resulting From Foreign Investments

The following are not as common in a typical hedge fund scenario, but are required in certain circumstances and can have significant penalties for non-compliance:

- **Form 5471** - Information Return of U.S. Persons With Respect to Certain Foreign Corporations
- **Form 8858** - Information Return of U.S. Persons With Respect to Foreign Disregarded Entities
- **Form TD F 90-22.1** – Report of Foreign Bank and Financial Accounts

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Form 926

- Filed at the individual level
  - Individual level includes U.S. Citizens, domestic corporations, estates and trusts.
  - Fund can not file on behalf of the partners.
  - Fund needs to provide information so partners can determine their filing requirements.
  - Code provides for significant penalties for non-filing.

Form 926

- Filing Threshold –
  - Cash Contribution: Must be filed if total contributions within 12 month period exceed $100,000, or if transferee has 10% of voting power or value.
  - Non-cash contributions: Non-recognition transactions must generally be reported, but there is a laundry list of items that could eliminate the filing requirement.

Form 8865

- Filing Form 8865 at the fund level when investing in a foreign partnership usually covers the individual partner's filing obligations.
  - Filing information needs to be disclosed to the partners in case they have additional filing requirements.
  - Penalties similar to that of Form 926

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Form 8865-Categories

Category 1 –

- Likely to occur in a Master Feeder Structure where the domestic feeder owns more than 50% of the capital or profits and losses of the Master Fund.
- Less likely at the individual owner level.
- Indirect owners may be able to bypass Form 8865 and replace with a statement if the downstream owner has filed Form 8865.
- If the Foreign Partnership files Form 1065, Categories 1 & 2 Filers may attach a completed copy of the Form 1065 from the Foreign Partnership in lieu of completing equivalent schedules of Form 8865

Form 8865-Categories

Category 2 –

- Not necessary to consider Category 2 when there was a Category 1 investor.
- Unlikely to occur in a Master Feeder Structure, since if the domestic fund didn't obtain 50% status to reach Category 1, then the offshore fund owns more than 50%, and the domestic fund and its partners won't meet the definition of control (50%).
- Most likely scenario to find a Category 2 individual is when domestic investors are allowed to invest as individuals directly in the offshore partnership.

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Form 8865-Categories

Category 3 –

- Contributor of $100,000 in property and/or cash in the 12 month period ending on the date of the transfer – or -
- Owned at least 10% of the fund immediately after a contribution.
- Category 3 filers who indirectly made contributions via domestic partnerships that also filed From 8865 are relieved of filing responsibility related to those contributions.
  - Potential scenarios include this contribution creating another filing requirement for the investor or relatives (attribution) who have other holdings in the same foreign fund.

Form 8865-Categories

Category 4 –

- Acquisition of or increase in direct ownership to 10% or higher.
- Acquisition causing increase in direct ownership interest of at least 10% since the last reportable event.
- Disposition of ownership interest that brings direct holding from over 10% to under 10%.
- Disposition causing decrease in direct ownership percentage of at least 10%.
- Change in direct proportional interest due to other factors that trigger any of the changes above.

PFIC Footnotes

First Rule: You really, really want to make a QEF election if you can.

- However, there are unusual cases where you don't.

Indirect PFIC Investment:

- If a lower-tier fund has made the QEF election, election is valid at the upper-tier fund level.
  - No need to file 8621 any more in this scenario (but that may change with current legislation).
  - If the fund made the election, they have included the income in the dividend or LT Capital gain lines of the K-1.

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PFIC Footnotes

Indirect PFIC Investment

- If lower-tier fund has not made QEF election, most likely it was because the PFIC doesn't provide the necessary info.
  - If lower-tier fund is a foreign partnership, the foreign partnership can't make the election and the investor will need to make the QEF election if information is available.
    - If this is the case, where did the lower tier fund include the PFIC information?

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PFIC Footnotes

Indirect PFIC Investment-No QEF

- If you were not able to make a QEF election, you will be computing income under the rules for a Section 1291 Fund.
  - Under Section 1291, all income is ordinary. No capital gains, even at sale.
  - Loss is still a capital loss.

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PFIC Footnotes

Indirect PFIC Investment-No QEF

Section 1291, Con't

- Excess Distributions
  - Distributed amounts that are over the average dividend threshold, and gains on sales of the PFIC are excess distributions.
  - Excess distributions need to be prorated over the holding period of the PFIC, and a deferred tax amount needs to be computed for those amounts.

PFIC Footnotes

Indirect PFIC Investment-No QEF

Section 1291, Con't

- Excess Distributions
  - The deferred tax amount needs to be computed at the highest rate available for your taxpayer in each year, even if they personally don't hit that tax rate.
  - Deferred interest then needs to be computed for each year, and compounded, as if you were late on the tax payment for each year.

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PFIC Footnotes

Indirect PFIC Investment-No QEF

Section 1291, Con't

- Unfortunately, when you see a line item on a K-1 that says "PFIC INCOME," this is the type of income you are receiving.
- We aren't aware of any software that will do the back tax and interest calculation for you.

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PFIC Footnotes

Indirect PFIC Investment-No QEF

Section 1291, Con't

- Why wouldn't a fund let its shareholders make a QEF election? It requires they agree to open up their books and records to the IRS, and most offshore partnerships do not wish to make that agreement. Plus, they then would have to supply tax calculations and statements to the owners.

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K-1 Preparation and Disclosures With Underlying K-1s

- Conformity with presentation of underlying K-1s
  - Line placement differences
  - State income and state tax withholdings
- Disclosures
  - Working with estimated lower-tier information
  - Waiting for the K1 that never arrives

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K-1 Preparation and Disclosures

- Form 8275
  - To use when not following a revenue ruling or revenue procedure.
- Form 8275-R
  - To use when not following Regulations
- Form 8082
  - To use when pass-through information from investments is not available or treated differently from pass-through K-1.

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UBTI (Unrelated Business Taxable Income)

- Must be considered in two areas:
  - Debt financing incurred at the fund level
  - UBTI incurred by lower-tier investments
- Methods for calculation
  - Specific identification
  - Capital gain vs. ordinary income items
- How to calculate
  - Percentage of debt/margin each period, or
  - Consideration of interest expense

ECI (Effectively Connected Income)

- General policy of most funds is to avoid effectively connected income.
  - If unavoidable, be prepared for withholding
  - If an offshore partnership is receiving the ECI (or a corporation treated as a partnership for U.S. tax purposes), be prepared to document ownership for withholding purposes
  - Foreign partners have federal and possibly state filing requirements upon receipt of ECI

State Filing Obligations of Hedge Funds

- Generally, most states have "trading for one's own account exemptions" that exempt nonresident hedge fund partners from taxes in those jurisdictions.
- Thus, hedge fund income is generally only sourced to the states of residencies of the hedge fund partners.
- Hedge Funds must however file informational returns in:
  - *Their state of commercial domicile* ***AND***
  - *Certain states that require funds to file if they have partners that are residents of those states* ***EVEN*** *if the Funds have* ***no*** *other nexus to those states*

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Common Resident Partner State Filing

- Georgia
- Maine
- Missouri
- New Jersey
- New York (Individuals, Estates, or Trusts)
- Oregon
- Pennsylvania
- West Virginia