



presents

Revised Federal Forms 1120 and 1065: Meeting the New IRS Demands

Compliance Strategies for Obtaining and Reporting Detailed Ownership Information

A Live 100-Minute Audio Conference with Interactive Q&A

Today's panel features:

Rick Olson, Principal, Corporate Tax, **Larson Allen**, Minneapolis
Jamie Lewis, Senior Tax Manager, **Clifton Gunderson**, Timonium, Md.
Jim Calzaretta, Partner, **Deloitte**, Washington, D.C.

Wednesday, August 12, 2009

The conference begins at:

1 pm Eastern

12 pm Central

11 am Mountain

10 am Pacific

The audio portion of this conference will be accessible by telephone only. Please refer to the dial in instructions emailed to registrants to access the audio portion of the conference.

CLICK ON EACH FILE IN THE LEFT HAND COLUMN TO SEE INDIVIDUAL PRESENTATIONS.

If no column is present: click **Bookmarks**  or **Pages**  on the left side of the window.

If no icons are present: Click **View**, select **Navigational Panels**, and chose either **Bookmarks** or **Pages**.

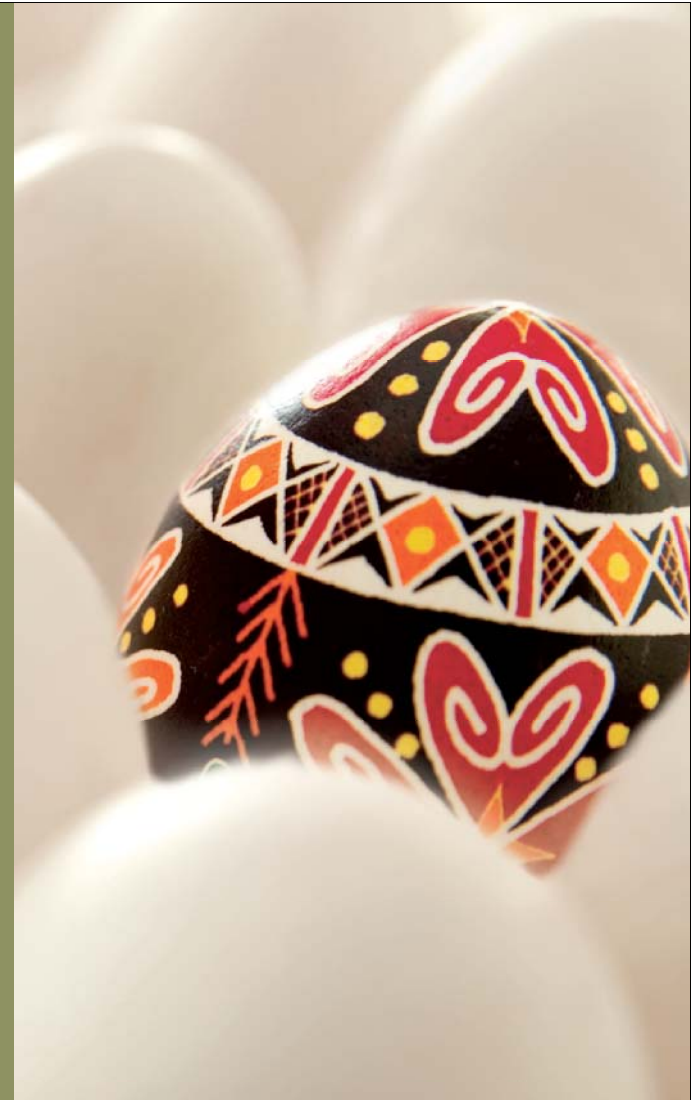
If you need assistance or to register for the audio portion, please call Strafford customer service at **800-926-7926 ext. 10**

Revised Forms 1120 And 1065 Teleconference

Aug. 12, 2009

Form 1120 Changes: Ownership Reporting On Schedule K

Rick Olson, LarsonAllen
rolson@larsonallen.com
(612) 376-4544



LarsonAllen
LLP
CPAs, Consultants & Advisors
www.larsonallen.com

NOTICEABLY
DIFFERENT

Learning Objectives

- Form 1120, Schedule K, *Other Information*
 - Understand the:
 - ◇ Reporting requirements
 - ◇ Definition of constructive ownership
 - Identify compliance issues



Agenda

- I. Why?
- II. When?
- III. What?
 - A. By the numbers (line numbers)
 - B. Constructive ownership defined
 - C. Between the lines – the issues



I. Why?

“...increase transparency about the ownership and relationships between entities that make up complex enterprise business structures. This will enable IRS to better assess compliance risk.”

- Frank Y. Ng, Commissioner of the Large and Mid-Size Business Division of the IRS



I. Why? (Cont.)

- Compliance risk = Need to audit complex structures
 - Ownership issues – Schedule K revisions
 - ◇ Indirect ownership = Constructive ownership
 - ◇ Also referred to as “attribution rules”
 - Transaction issues with related parties – New Schedule B



II. When?

- 2008 Form 1120, U.S. Corporation Income Tax Return
 - Applies to fiscal years beginning in 2008



III. What? By The Numbers – Line 4

- Ownership of the corporation
 - *Directly 20% or more*
 - *Directly or indirectly 50% or more*
- Ownership by:
 - 4 a) Foreign or domestic entity
 - ◇ Corporation
 - ◇ Partnership - includes LLC “treated as a partnership”
 - ◇ Trust
 - 4 b) Individual or estate



III. What? By The Numbers – Line 5

- Ownership by the corporation
 - *Directly 20% or more*
 - *Directly or indirectly 50% or more*
- Ownership of foreign or domestic:
 - 5 a) Corporation
 - ◇ Not already reported on Form 851, Affiliations Schedule
 - 5 b) Partnership - includes LLC “treated as a partnership”



III. What? By The Numbers – Lines 4 & 5

- Measurement:
 - End of year
 - Corporation: Total voting power of all stock classes entitled to vote
 - Partnership: Interest in profit, loss or capital
 - Indirect ownership = “constructive ownership”
 - ◇ Defined by Sect. 267(c)
 - Excludes Sect. 267(c)(3) – “partner attribution”



III. What? By The Numbers – Lines 4 & 5 (Cont.)

- Reporting required if criteria is met:
 - Name
 - EIN (if any)
 - Corporation: *Percentage owned in voting stock*
 - Partnership: *Maximum percentage owned in profit, loss, or capital*



III. What? Constructive Ownership

- Sect. 267(c) contains five rules:
 - 1) Stock owned, directly or indirectly, by an entity is owned proportionately by the entity's owners (e.g. shareholders, partners or beneficiaries)
 - 2) An individual is the owner of stock owned, directly or indirectly, by or for his or her family
 - 3) Partner attribution (not applicable to Schedule K)
 - 4) Family includes siblings, spouse, ancestors and lineal descendants
 - 5) Restrictions on "double attribution"; modified by Form 1120 instructions



III. What? Constructive Ownership (Cont.)

- Sect. 267(c)(5) – “double attribution” rule; stock constructively owned under rule:
 - (1) Is considered to be actually owned, for purposes of applying rules (1) or (2) [See modification]
 - (2) Is not considered to be actually owned, for purposes of again applying rule (2)
- Modification made by the instructions:
 - Rule (2) will not attribute stock ownership to a family member unless the individual also owns an interest directly or indirectly under Rule (1)



III. What? Constructive Ownership Example

- Example 2 from the instructions
 - Individual A owns directly 50% of the voting stock of Corporation X
 - Individual B is A's daughter
 - B does not have any direct ownership in X
 - B does not have indirect ownership under Rule (1)
 - Reporting on Schedule K, line 4 b)
 - ◇ A: Ownership interest will be reported as 50%
 - ◇ B: No ownership interest will be reported
- Observation
 - B would normally be considered to own 50% under Rule (2); however the instructions modify the result



III. What? Constructive Ownership

- Additional clarifications:
 - Sect. 267 attribution differs from other attribution rules
 - The family definition under rule (2) includes:
 - Siblings by whole or half blood
 - Ancestors and descendants include two generations (Reg. 1.267(c)-1(a)(4))
 - ◇ E.g., ancestors include parents and grandparents
 - Full effect shall be given to a legal adoption



III. What? - Issues

- Consolidated return filing requirement – must be an *affiliated group*
 - Sect. 1504; 80% voting and value
- Limitation on tax benefits to *controlled group*
 - Sect. 1563; 50% common ownership
 - Tax benefits subject to limitation include:
 - ◊ Tax brackets (“surtax exemption”)
- Limitations on net operating losses
 - Sect. 382; 50% *ownership change or equity shift*



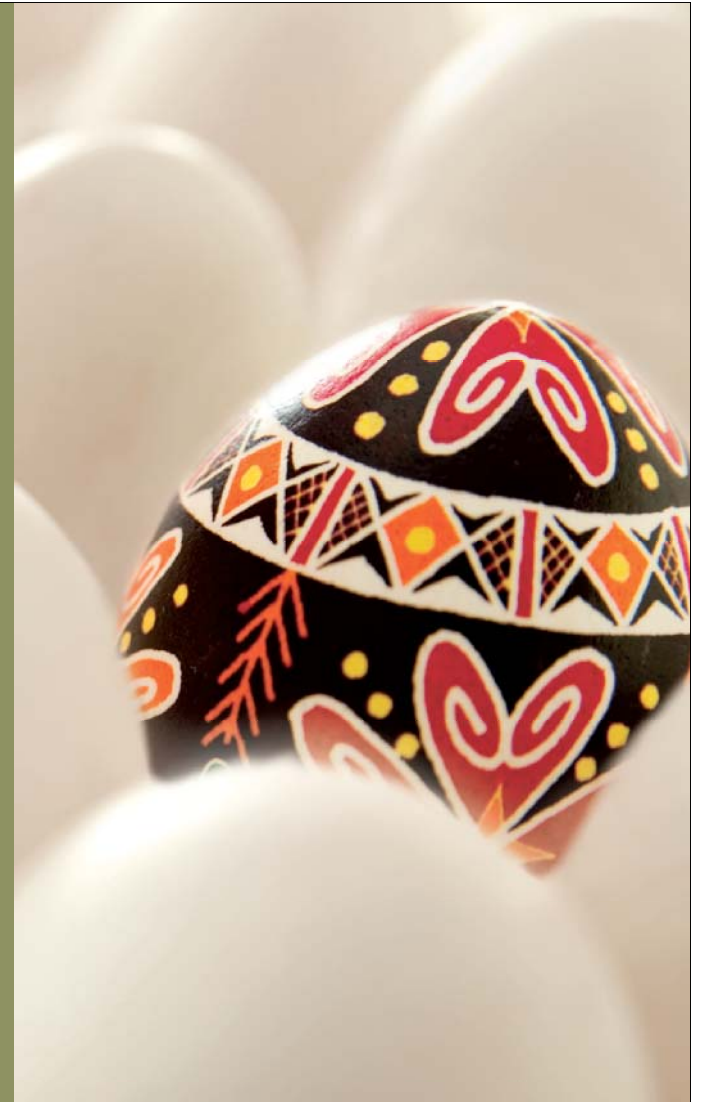
III. What? – Issues (Cont.)

- Potential requirements for additional filings
 - Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*
 - Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*
 - Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts*
- Quantifying exposures under FIN 48



Thank you!!!

Rick Olson
rolson@larsonallen.com
612-376-4544



LarsonAllen
LLP
CPAs, Consultants & Advisors
www.larsonallen.com

NOTICEABLY
DIFFERENT

Revised Federal Forms 1120 And 1065 Teleconference

Aug. 12, 2009

Form 1120 Schedule B

**Jamie Lewis, Clifton
Gunderson**

Jamie.Lewis@cliftoncpa.com



Schedule B: Additional Information For M-3 Filers

Schedule B must be filed by all corporations that file a Form 1120 and are required to file Schedule M-3

This schedule will provide the IRS information about:

- Cost allocations and cost-sharing arrangements
- Transfers of interest
- Changes in methods of accounting
- Compliance changes necessary to correctly meet reporting requirements

Partnership Income Allocations

- Question 1: Do the amounts reported on Schedule M-3 (Form 1120), Part II, lines 9 or 10, column (d), reflect allocations to this corporation from a partnership of income, gain, loss, deduction or credit that are disproportionate to this corporation's capital contribution to the partnership or its ratio for sharing other items of the partnership?
- Question 1 deals with special allocations of income, gain, loss, deduction or credit from a partnership
- If the taxpayer received a special allocation, question 1 needs to be marked "yes"
- Example: X corporation joins with Y, an individual in forming the XY partnership. Each contribute \$50,000 cash with profit and losses allocated equally. Depreciation is allocated 99% to X and 1% to Y
- Question 1 would be answered "yes" because the allocation of depreciation is not proportionate to the ratio of other items from the partnership (50% each)

Sell, Exchange, Acquire Or Transfer Of Interest In Intangible Assets

- Question 2: At any time during the tax year, did the corporation sell, exchange, or transfer any interest in an intangible asset to a related person as defined in I.R.C. Sect. 267(b)?
- Question 3: At any time during the tax year, did the corporation acquire any interest in an intangible asset from a related person as defined in I.R.C. Sect. 267(b)?
- I.R.C. Sect. 267(b) details the various relationships that fall under I.R.C Sect. 267

I.R.C. Sect. 267(b) Relationships

- Members of family: brothers, sisters, spouse, ancestors and lineal descendants
- An individual and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual
- Two corporations which are members of the same controlled group
- A grantor and a fiduciary of any trust
- A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts
- A fiduciary of a trust and a beneficiary of such trust
- A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts

I.R.C. Sect. 267(b) Relationships (Cont.)

- A fiduciary of a trust and a corporation more than 50% in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust
- A person and an organization to which Sect. 501 applies and which is controlled directly or indirectly by such person or by members of the family of such individual
- A corporation and 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 interest, or the profits interest, in the partnership
- An S corporation and another S or C corporation if the same persons own more than 50% in value of the outstanding stock of each corporation
- Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate

Cost-Sharing Arrangements

- Question 4a: During the tax year, did the corporation enter into a cost-sharing arrangement with any related foreign party on whose behalf the corporation did not file Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations?
 - Current-year transaction
- Question 4b: At any time during the tax year, was the corporation a participant in a cost-sharing arrangement with any related foreign party on whose behalf the corporation did not file Form 5471?
 - Cost-sharing arrangement could have been established in prior years
- Generally, why would a taxpayer not file Form 5471?
 - Does fit into one of the four categories of filers listed out in the form's instructions; or,
 - Meets one of the exceptions for filing also listed out in the form's instructions

Change In Accounting Principle

- Question 5: At any time during the tax year did the corporation make any change in accounting principal for financial accounting purposes?
- “Change in accounting principle “ means a change from one generally accepted accounting principle to another generally accepted accounting principle as described in Statement of Financial Accounting Standards No. 154 – Accounting Changes and Error Corrections
- Answer “yes” only if the change that occurred during the tax year affected or is expected to affect the amount of income reported for financial statement purposes
- Tax preparer note: These changes should be readily identifiable within the footnotes of the financial statements

Change In Accounting Method

- Question 6: At any time during the tax year, did the corporation make any change in a method of accounting for U.S. income tax purposes?
- Generally, Form 3115 would be part of the current year return if one was to answer “yes” to this question

VEBA Trusts

- Question 7: At any time during the tax year, did the corporation own any voluntary employees' beneficiary association (VEBA) trusts that were used to hold funds designated for employee benefits?
 - When employers establish and fund welfare benefit plans on behalf of their employees through a tax-exempt trust

Mixed Service Costs

- Question 8: At any time during the tax year, did the corporation use an allocation method for mixed service costs that varied from the Federal Energy Regulatory Commission (FERC) method of accounting?
- Question is directed towards certain utilities that are subject to a regulatory method of accounting imposed by the FERC to determine which expenditures are capitalized or expensed rather than I.R.C. Sect. 446
- Answer “yes” if the corporation is subject to FERC accounting during the year and used an allocation method for mixed-service costs that varied from the FERC method of accounting

New Developments!

- Latest draft proposes to remove one question and pose three new questions
- FERC question is removed
- New question 8: At any time during the tax year, did the corporation use an allocation method for indirect costs capitalized to self-constructed assets that varied from its financial method of accounting?
- Question 9: At any time during the tax year, did the corporation treat for tax purposes indirect costs, as defined in regulations sections 1.263A-1(e)(3)(ii)(F), (G), and (H), as mixed-service costs, as defined in regulations Sect. 1.263A-1(e)(ii)(C)?

New Developments! (Cont.)

- Question 10: Did the corporation, under sections 118 or 362(c) and the related regulations, take a return-filing position characterizing any amount as a contribution to the capital of the corporation during the tax year by any non-shareholders? Amounts so characterized may include, without limitation, incentives, inducements, money and property

Revised Federal Forms 1120 And 1065 Teleconference

Aug. 12, 2009

Form 1065 Revisions

**Jim Calzaretta, Deloitte Tax
jcalzaretta@deloitte.com**

New Schedule B – Additional Ownership Disclosures

Q2 - Was any partner in the partnership a disregarded entity, a partnership, a trust, an S corporation, an estate or nominee or a similar person?

- Expands on the 2007 question, which only inquired as to whether any partners in the partnership were also partnerships
- If the answer to this question is “yes,” then the partner is subject to TEFRA

New Schedule B – Additional Ownership Disclosures (Cont.)

Q3a - Did any foreign or domestic corporation, partnership or trust own, directly or indirectly, an interest of 50% or more in the profit, loss or capital of the partnership at the end of the tax year? If so, need to include name of entity, EIN, type of entity, country of organization, and maximum percentage owned in profit, loss, or capital

- Allows the IRS to indentify potential filing requirements for Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*

New Schedule B – Additional Ownership Disclosures (Cont.)

Q3b - Did any individual or estate own, directly or indirectly, an interest of 50% or more in the profit, loss, or capital of the partnership at the end of the tax year? If so, need to include name of individual or estate, SSN or EIN, country of citizenship, and maximum percentage owned in profit, loss or capital

- Constructive ownership rules of Sect. 267(c) apply [excluding Sect. 267(c)(3)] to Q3a and Q3b
 - Example: Husband and wife each own a 50% interest in the partnership's profit, loss and capital. Pursuant to Sect. 267(c), husband and wife each indirectly own 100% of the profit, loss or capital of the partnership
 - The constructive ownership rules only apply to direct or indirect partners. For example, if A owns a 75% interest in the partnership and a 100% interest in corporation (which does not own an interest in partnership), the corporation will not be included on Q3
- Look to maximum percentage of ownership in profit, loss or capital at the end of the year for Q3a and Q3b
 - Example: Individual owns 20% interest in profits, 60% interest in losses, and 30% interest in capital at the end of the year. The amount reported by the partnership on Q3b will be 60%

New Schedule B – Additional Ownership Disclosures (Cont.)

For purposes of determining whether a corporation, partnership, individual or estate owned, directly or indirectly, 50% or more of the partnership at the end of the tax year, IRS FAQ 23 provides that the partnership is required to request and obtain any necessary information from its partners sufficient for the partnership to reach a proper conclusion

If the partners refuse or fail to provide the necessary information, and the partnership does not have sufficient information to reach a proper conclusion, the partnership must disclose the refusal by stating “Requested Ownership Information Refused or Not Provided” on line 3a or 3b, or both, as appropriate

New Schedule B – Additional Ownership Disclosures (Cont.)

Q4a - Did the partnership 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, at the end of the tax year? If so, need to include the name of the corporation, EIN, country of incorporation, and percentage owned in voting stock

- Allows the IRS to identify potential filing requirements for Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*

New Schedule B – Additional Ownership Disclosures (Cont.)

Q4b - Did the partnership 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 or in the beneficial interest of a trust at the end of the tax year? If so, need to include name of entity, EIN, type of entity, country of organization, and maximum percentage owned in profit, loss, or capital

- If a corporation or partnership is owned by the partnership through a disregarded entity, the information for the corporation or partnership, rather than the information for the disregarded entity, is included
- Allows the IRS to identify potential filing requirements for Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*

New Schedule B – Change To Thresholds For Requirement To File Schedules L, M-1, M-2, Etc.

Q6 - The partnership is not required to complete Schedules L, M-1, M-2, etc. if all of the following requirements are met:

- The partnership's total receipts for the tax year were less than \$250,000
 - The partnership's total assets at the end of the tax year were less than \$1 million
 - 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
 - The partnership is not filing and is not required to file Schedule M-3
- The 2008 form changes the threshold for total assets at the end of the tax year from \$600,000 to \$1,000,000 and adds a new requirement regarding the filing of Schedule M-3
 - Intent was to decrease the reporting burden on small partnerships

New Schedule B - New Information About Cancelled Debt

Q8 - Did the partnership have any debt during the year that was cancelled, forgiven, or had the terms modified so as to reduce the principal amount of the debt?

- Provides information about cancelled debt and possible cancellation of debt income

New Schedule B - Expansion On Question Re: Sect. 754 Elections

Q 12 – (a) Is the partnership making, or had it previously made (and not revoked), a Sect. 754 election?

(b) Did the partnership make for the tax year an optional basis adjustment under Sect. 743(b) or 734(b)? If “yes,” attach a statement showing the computation and allocation of the basis adjustment

(c) Is the partnership required to adjust the basis of partnership assets under sections 743(b) or 734(b) because of a substantial built-in loss or substantial basis reduction? If “yes,” attach a statement showing the computation and allocation of the basis adjustment

- Provides information on whether a Sect. 754 election is in place and whether the partnership is making adjustments under sections 734(b) or 743(b)

New Schedule B – More Disclosure Of Like-Kind Exchanges

Q13 - During the current or prior tax year, did the partnership distribute any property received in a like-kind exchange or contribute such property to another entity (including disregarded entities)?

- Provides information about like-kind exchanges in which the partnership may have participated for which the property was subsequently transferred

New Schedule B – New Information On Distributions Of Tenancy-In-Common Or Other Undivided Interest In Property

Q14 – 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?

- Provides information that might help identify if the distributed property is a partnership interest

New Schedule C

Required to be completed by filers of Schedule M-3
(Form 1065), *Net Income (Loss) Reconciliation for Certain
Partnerships*

New Schedule C - Information About Related-Party Transactions

Q1 - At any time during the tax year, were there any transfers between the partnership and its partners subject to the disclosure requirements of regulations Sect. 1.707-8?

- Allows IRS to identify potential disguised sales

New Schedule C - Allocations

Q2 - Do the amounts reported on Schedule M-3, Part II, lines 7 or 8, column (d), reflect allocations to the partnership from another partnership of income, gain, loss, deduction or credit that are disproportionate to the partnership's share of capital in such partnership or its ratio for sharing other items of such partnership?

- Allows IRS to identify special allocations of items from other partnerships

New Schedule C – Transfers Of Interest

Q3 - At any time during the tax year, did the partnership sell, exchange or transfer any interest in an intangible asset to a related person as defined in sections 267(b) or 707(b)(1)?

Q4 - At any time during the tax year, did the partnership acquire any interest in an intangible asset from a related person as defined in sections 267(b) and 707(b)(1)?

- Allows IRS to identify potential anti-churning transactions under Sect. 197

New Schedule C – Changes In Methods Of Accounting

Q5 - At any time during the tax year, did the partnership make any change in accounting principle for financial accounting purposes?

Q6 - At any time during the tax year, did the partnership make any change in a method of accounting for U.S. income tax purposes?

- Allows IRS to identify method changes without IRS permission and changes in methods of accounting

Changes To Schedule K-1 – New Instructions For Item J

2008 instructions state to enter the partner's share of the partnership's profit, loss and capital as of the beginning and end of the partnership's tax year, as determined under the partnership agreement

2007 instructions state to enter the partner's appropriate percentages at the beginning and the end of the year. There was no mention of using the percentages as determined under the partnership agreement

Changes To Schedule K-1 – New Instructions For Item J (Cont.)

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, as long as the method is consistent with the partnership agreement and is applied consistently from year to year

The partner's share of each category must be expressed as a positive percentage, and each category must total 100% for all partners

Changes To Schedule K-1 – Determination Of Partners’ Shares Of Profits, Losses And Capital - IRS FAQ 1 (Cont.)

IRS FAQ 1 – How may the partners’ shares of profit, loss and capital be reported in cases where the partnership agreement does not express such items as percentages?

The following is provided as an example of a reasonable method of calculating partners’ percentage shares of profit, loss, and capital for purposes of completing Form 1065 Schedule B questions 3 and 4, and for purposes of completing Schedule K-1 item J, for the tax years ending on or after Dec. 31, 2008:

This example is provided solely for purposes of assisting the partnership return preparer in calculating the partners’ percentage shares of profit, loss and capital as required by Schedule K-1 Item J and Schedule B, questions 3 and 4

Partners A and B are partners in Partnership AB. At the beginning of 2008, Partner A and Partner B had capital account balances of \$2,000 and \$667, respectively. The AB partnership agreement requires capital accounts to be maintained in accordance with Sect. 704(b)

Changes To Schedule K-1 – Determination Of Partners' Shares Of Profits, Losses And Capital - IRS FAQ 1 (Cont.)

The partnership agreement does not express the partners' shares of profit, loss and capital as fixed percentages. In 2008, Partnership AB adopts the following method for determining the percentages of capital, profit and loss to be used in completing Schedule K-1, item J and Schedule B, questions 3 and 4

Partnership AB computes the partners' end of tax year percentages of capital by dividing each partner's positive capital account balances on the last day of the partnership's tax year by the total positive capital account balances on the last day of the partnership's tax year, and expressing the result as a percentage. Partnership AB reports a negative capital account balance as a zero percentage. Partnership AB reports the prior year end of tax-year percentages of capital as the beginning of tax-year percentages of capital

Partnership AB computes the partners' percentages of profit for the tax year as each partner's share of items which increased partnership capital during the tax year, other than contributions to capital. Partnership AB computes the partners' percentages of loss for the tax year as each partner's share of items which decreased partnership capital during the tax year, other than distributions

Changes To Schedule K-1 – Determination of Partners’ Shares Of Profits, Losses And Capital - IRS FAQ 1 (Cont.)

The partnership agreement allocates Sect. 704(b) profits and losses for the tax year as follows: 1) first to Partner A as a preferred return on capital equal to 5% of Partner A’s beginning capital balance, 2) then 80% to Partner A and 20% to Partner B until Partner A is allocated profits equal to an aggregate 10% preferred return on Partner A’s beginning capital balance. Any residual profits or losses are allocated 60% to Partner A and 40% to Partner B. Allocations of taxable income or loss follow the Sect. 704(b) allocations, and Partnership AB uses the Sect. 704(c) traditional method to account for any differences between section 704(b) profits and losses and tax profits and losses

For the tax year ended Dec. 31, 2008, Partnership AB generated \$1,000 of Sect. 704(b) profits and \$900 in taxable income. In accordance with the AB partnership agreement, Partner A is allocated \$665 of Sect. 704(b) profits as follows: 1) \$100 of the first \$100 of profits equal to a 5% preferred return on Partner A’s beginning capital, 2) an additional \$100 of the next \$125 of profits equal an aggregate 10% preferred return on Partner A’s beginning capital, and 3) \$465 of the remaining \$775 in profits, which is equal to 60% of Partnership AB’s residual profits. Partnership AB allocates all tax items to follow the Sect. 704(b) allocations, with the exception of a \$100 capital loss which was solely allocated to Partner A under Sect. 704(c)

Changes To Schedule K-1 – Determination Of Partners' Shares Of Profits, Losses And Capital - IRS FAQ 1 (Cont.)

Profit percentages – Partner A's percentage share of partnership profits for the tax year is 66.5% [\$665 divided by \$1,000]

Loss percentages – Partner A's percentage share of partnership losses for the year is 0%. Even though a \$100 loss was allocated to Partner A under Sect. 704(c), this loss did not affect his Sect. 704(b) capital account. Thus, because he was allocated no losses that would affect capital accounts, his percentage share is 0. Likewise, Partner B was allocated no losses that would impact his Sect. 704(b) capital account, and Partner B's percentage share of partnership losses is 0%

If Partnership AB had a net loss for the year for the Sect. 704(b) capital accounts, Partner A's percentage share of the net loss would be 60% and Partner B's percentage share of the net loss would be 40% under the agreement, and the reasonable method adopted for Item J. In such case, Partner A's percentage share of profit would be 0% and Partner B's percentage share of profit would also be 0%

Capital percentages – Partner A's share of total Sect. 704(b) capital at the end of the tax year is \$2,665 (\$2,000 plus \$665). Partner A's share of capital computed as a percentage of total partnership Sect. 704(b) capital is 72.68% (\$2,665 divided by \$3,667). Partner B's share of total Sect. 704(b) capital at the end of the tax year is \$1,002 (\$667 plus \$335). Partner B's share of capital computed as a percentage of total partnership Sect. 704(b) capital is 27.32% (\$1,002 divided by \$3,667)

Changes To Schedule K-1 – Determination Of Partners' Shares Of Profits, Losses And Capital

Exceptions to requirement that percentages must total 100% for all partners, if the partnership agreement does not specify the fixed percentages:

- If partnership solely has Sect. 704(b) losses for the year, profit percentage will be 0%
- If no partner is allocated losses that would be allocated to their Sect. 704(b) capital accounts, loss percentage will be 0%
- If a partner has a negative capital account, his capital percentage will be 0%. IRS FAQs 1,3, and 16 indicate that this is reasonable. A DRO will not change the answer

For example, IRS FAQ 31 indicates that two equal partners in a partnership with \$1,000 ordinary income and \$500 capital loss should report 50% end of year profit, loss and capital percentages. This answer differs from the answer in IRS FAQ 1 because, in IRS FAQ 1, the capital loss is a Sect. 704(c) capital loss and, in IRS FAQ 31, the capital loss is a Sect. 704(b) capital loss

Changes To Schedule K-1 – Determination Of Partners' Shares Of Profits, Losses And Capital (Cont.)

Note the inconsistency between the instructions to the Form 1065 and the IRS FAQs. According to the instructions to the Form 1065, the total percentage interest in each category must total 100% for all partners

However, the IRS FAQs state that a reasonable method is one in which the partners' percentages total 0% for a category if, for example, no partner is allocated a loss that would impact its Sect. 704(b) capital account

Changes To Schedule K-1 – Determination Of Partners' Shares Of Profits, Losses And Capital (Cont.)

The IRS has indicated that they view the use of Sect. 704(b) capital accounts as the “gold standard” in determining the partners' percentage shares of profit, loss and capital, but they acknowledge that other basis (i.e., GAAP) may also be appropriate to use

Bottom line: Use the method you want, as long as you can explain why it is reasonable and be able to show that it is consistent with the partnership agreement and be sure to use that method consistently from year to year

Changes To Schedule K-1 – Determination Of Partners' Shares Of Profits, Losses And Capital (Cont.)

In situations where the percentages change during the year, a statement must be attached to the Schedule K-1 listing the dates and percentages for actual changes in ownership. This does not apply to changes in percentages resulting from fluctuations in profit allocations during the year due to formula methods specified in the partnership agreement

Changes To Schedule K-1 – Determination Of Partners' Shares Of Profits, Losses And Capital (Cont.)

If the partnership changes the reasonable method used for 2009 from the reasonable method used for 2008, the partnership must attach to its 2009 tax return:

- A statement explaining why the change was necessary; and
- A schedule comparing each partner's end-of-year percentage interests in the partnership's profit, loss and capital under the new method and the method used in 2008

Changes To Schedule K-1 – Determination Of Partners’ Shares Of Profits, Losses And Capital (Cont.)

The 2009 Schedules K-1s cannot show “various” for the beginning of year percentages. The same method used to calculate end of year percentages must be used to calculate beginning-of-year percentages

According to IRS FAQ 29, if the partnership is unable to determine the beginning-of-year percentages for profit and loss, it should indicate “Unknown” as the beginning-of-year 2008 percentages

Best Practices And Potential Audit Exposure With The Revised Forms

- What issues should taxpayers expect?

Deloitte.

Background - IRS Form 1120:

<http://www.irs.gov/pub/irs-pdf/f1120.pdf>

Background - IRS Form 1120 Instructions:

<http://www.irs.gov/pub/irs-pdf/i1120.pdf>

Background - IRS Form 1065:

<http://www.irs.gov/pub/irs-pdf/f1065.pdf>

Background - IRS Form 1065 Instructions:

<http://www.irs.gov/pub/irs-pdf/i1065.pdf>

Background - IRS Form 1065 Schedule K1:

<http://www.irs.gov/pub/irs-pdf/f1065sk1.pdf>

Background - IRS Form 1065 Schedule K-1 Instructions:

<http://www.irs.gov/pub/irs-pdf/i1065sk1.pdf>

Background - IRS Form 1065 Schedule C:

<http://www.irs.gov/pub/irs-pdf/f1065sc.pdf>

Background - IRS Form 1065 Schedule C Instructions:

<http://www.irs.gov/pub/irs-pdf/i1065sc.pdf>