



# Shareholder's Instructions for Schedule K-1 (Form 1120S)

## Shareholder's Share of Income, Deductions, Credits, etc. (For Shareholder's Use Only)

Section references are to the Internal Revenue Code unless otherwise noted.

### General Instructions

#### Purpose of Schedule K-1

The corporation uses Schedule K-1 to report your 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 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. Use these instructions to help you report the items shown on Schedule K-1 on your tax return.

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 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* beginning on this page for more information.

Schedule K-1 does not show 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.

#### Inconsistent Treatment of Items

Generally, you must report corporate items shown on your Schedule K-1 (and any attached schedules) the same way that the corporation treated the items on its return.

If the treatment on your original or amended return is inconsistent with the corporation's treatment, or if the corporation has not filed a return, file Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR), with your original or amended return to identify and explain any inconsistency (or to note that a corporate return has not been filed).

If you are required to file Form 8082 but do not do so, you may be subject to the accuracy-related penalty. This penalty is in addition to any tax that results from making your amount or treatment of the item consistent with that shown on the corporation's return. Any deficiency that results from making the amounts consistent may be assessed immediately.

#### Errors

If you believe the corporation has made an error on your Schedule K-1, notify the corporation and ask for a corrected Schedule K-1. Do not change any items on your copy of Schedule K-1. Be sure that the corporation sends a copy of the corrected Schedule K-1 to the IRS. If you are unable to reach agreement with the corporation regarding the inconsistency, file Form 8082.

#### International Boycotts

Every corporation that had operations in, or related to, a boycotting country, company, or a national of a country must file Form 5713, International Boycott Report.

If the corporation cooperated with an international boycott, it must give you a copy of its Form 5713. You must file your own Form 5713 to report the corporation's activities and any other boycott operations that you may have. You may lose certain tax benefits if the corporation participated in, or cooperated with, an

international boycott. See Form 5713 and its instructions for details.

#### 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).

#### Additional Information

For more information on the treatment of S corporation income, deductions, credits, etc., see Pub. 535, Business Expenses; Pub. 550, Investment Income and Expenses; and Pub. 925, Passive Activity and At-Risk Rules.

To get forms and publications, see the instructions for your tax return or visit the IRS website at [www.irs.gov](http://www.irs.gov).

#### Limitations on Losses, Deductions, and Credits

There are three potential limitations on corporate losses that you can 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. These limitations are discussed 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. For details and exceptions, see section 1366(d). The basis of your stock is generally figured at the end of the corporation'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.

You are responsible for keeping the information needed to figure the basis of your stock in the corporation. Schedule K-1 provides information to help you figure your stock basis 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 for Figuring a Shareholder's Stock Basis* 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.



*You must report on your return (if you are required to file one) any amount required to be included in gross income for it to increase your basis.*



*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 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) prior to decreasing your basis under (3). 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,

**Worksheet for Figuring a Shareholder's Stock Basis**

Keep for Your Records



1. Your stock basis at the beginning of the year	1. _____
<b>Increases:</b>	
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. _____
<b>Decreases:</b>	
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 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 the end of the year. Combine lines 1 through 8	9. _____ 0.00

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.

**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) on page 2 not used to offset amounts in (1) on page 2, or reduce your stock basis, are used to reduce your loan basis (to the extent of such basis prior to such reduction).



*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.

See section 1367 and its regulations for more details.

**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:

- 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
- 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 (your economic loss) 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 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 the 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 person related 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 the activity or from a person related 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 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.

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. 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, 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. See the instructions for these forms for details.

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 on page 3), in each rental real estate activity held through the corporation. All determinations of material participation are 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. See the Instructions for Form 8582 for details.

**Individuals.** If you are an individual, 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 corporation) 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.

**Work counted toward material participation.** Generally, any work that you or your spouse does in connection with an activity held through an S corporation (where you own your stock 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, 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 (defined on page 3) 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 if 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 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, 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, file a separate return for the year, and did not live apart from your spouse at all times during the year.

Only individuals 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 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

