

# Instructions for Form 1065

## U.S. Return of Partnership Income

Volume 2 of 6



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# **Elections Made by the Partnership**

Generally, the partnership decides how to figure income from its operations. For example, it chooses the accounting method and depreciation methods it will use. The partnership also makes elections under the following sections.

1. Section 179 (election to expense certain property).
2. Section 614 (definition of property—mines, wells, and other natural deposits). This election must be made before the partners figure their individual depletion allowances under section 613A(c)(7) (D).
3. Section 1033 (involuntary conversions).
4. Section 754 (manner of electing optional adjustment to basis of partnership property).

Under section 754, a partnership may elect to adjust the basis of partnership property when property is distributed or when a partnership interest is transferred. If the election is made regarding a transfer of a partnership interest (section 743(b)) and the assets of the partnership constitute a trade or business for purposes of section 1060(c), then the value of any goodwill transferred must be determined in the manner provided in Regulations section 1.1060-1. Once an election is made under section 754, it applies both to all distributions and to all transfers made during the tax year and in all subsequent tax years unless the election is revoked.

This election must be made in a statement that is filed with the partnership's timely filed return (including any extension) for the tax

year during which the distribution or transfer occurs. See Regulations section 1.754-1(b)(1). The statement must include:

- a. The name and address of the partnership, and
- b. A declaration that the partnership elects under section 754 to apply the provisions of section 734(b) and section 743(b). A declaration that the partnership elects under section 754 to apply the provisions of section 734(b) and section 743(b).

The partnership can get an automatic 12-month extension to make the section 754 election, provided corrective action is taken within 12 months of the original deadline for making the election. For details, see Regulations section 301.9100-2.

See section 754 and the related regulations for more information.

If there's a distribution of property consisting of an interest in another partnership, see section 734(b).

The partnership is required to attach a statement for any section 743(b) basis adjustments. See below for details.

To revoke a section 754 election, the partnership must file the revocation request using Form 15254, Request for Section 754 Revocation. See the instructions for Form 15254 for more information.

5. Section 743(e) (electing investment partnership).
6. Regulations section 1.1411-10(g) (section 1411 election regarding controlled foreign corporations (CFCs) and qualified electing fund (QEF)).

A domestic partnership that directly or indirectly owns stock of a CFC (within the meaning of section 953(c)(1)(B) or section 957(a)) or a passive foreign investment company (PFIC) (within the meaning of section 1297(a)) that the domestic partnership treats as a QEF under section 1293 may make the election provided in Regulations section 1.1411-10(g). The election must be made no later than the first tax year beginning after 2013 during which the partnership:

- a. Includes an amount in gross income for chapter 1 purposes under section 951(a) or section 1293(a)(1)(A) for the CFC or QEF, and
- b. Has a direct or indirect owner that is subject to tax under section 1411 or would have been if the election were made.

This election must be made on an entity-by-entity basis, and applies only to the particular CFCs and QEFs for which an election is made. In general, for purposes of section 1411, if an election is in effect for a CFC or QEF, the amounts included in income under section 951 and section 1293 derived from the CFC or QEF are included in net investment income, and distributions described in section 959(d) or section 1293(c) are excluded from net investment income. An election that is made under Regulations section 1.1411-10(g) can't be revoked. For more information regarding this election, see Regulations section 1.1411-10(g).

The election must be made in a statement that is filed with the partnership's original or amended return for the tax year in which the



election is made. An election can be made on an amended return only if the tax year for which the election is made, and all tax years affected by the election, aren't closed by the period of limitations on assessments under section 6501. The statement must include:

The name and EIN of the partnership making the election;

A declaration that the partnership elects under Regulations section 1.1411-10(g) to apply the rules in Regulations section 1.1411-10(g) to the CFCs and QEFs identified in the statement; and

The following information for each CFC and QEF for which an election is made:

- (a) the name of the CFC or QEF; and
- (b) either the EIN of the CFC or QEF, or, if an EIN isn't available, the

reference ID number of the CFC or QEF.

7. Section 41(h) (payroll tax credit election).

## **Effect of Section 743(b) Basis Adjustment on Partnership Items**

If the basis of partnership property has been adjusted for a transferee partner under section 743(b), the partnership must adjust the transferee's distributive share of the items of partnership income, deduction, gain, or loss in accordance with Regulations sections 1.743-1(j)(3) and (4). These adjustments (other than adjustments to depletable oil and gas property allocable to the partner under section 613A(c)(7)(D)) must be reported on Schedule K and the transferee partner's Schedule K-1. Report the adjustments on an attached statement to Schedule K, line 20c, code U. See the instructions for Schedule K, line 20. Identify

the partnership item being adjusted and the amount of the adjustment. If the adjustments are to partnership items from more than one trade or business, report the adjustments separately for each activity.

## **Electing Out of the Centralized Partnership Audit Regime**

A partnership can elect out of the centralized partnership audit regime for a tax year if the partnership is an eligible partnership that year. See Question 31 under *Schedule B*, later.

## **Elections Made by Each Partner**

Elections under the following sections are made by each partner separately on the partner's tax return.

- Section 59(e) (election to deduct ratably certain qualified expenditures such as intangible drilling costs, mining exploration expenses, or

research and experimental expenditures).

- Section 108 (income from discharge of indebtedness).
- Section 617 (deduction and recapture of certain mining exploration expenditures paid or incurred).
- Section 901 (foreign tax credit).

## **Partner's Dealings With Partnership**

If a partner engages in a transaction with the partnership, other than in the capacity as a partner, the partner is treated as not being a member of the partnership for that transaction. Special rules apply to sales or exchanges of property between partnerships and certain persons, as explained in Pub. 541.

## **Contributions to the Partnership**

Generally, no gain (loss) is recognized to the partnership or any of the partners when property is contributed to the partnership in exchange for an interest in the partnership. This rule doesn't apply to any gain realized on a transfer of property to a partnership that would be treated as an investment company (within the meaning of section 351(e)) if the partnership were incorporated. If, as a result of a transfer of property to a partnership, there's a direct or indirect transfer of money or other property to the transferring partner, the partner may have to recognize gain on the exchange.

The basis to the partnership of property contributed by a partner is the adjusted basis in the hands of the partner at the time it was contributed, plus any gain recognized (under section 721(b)) by the partner at that time. See section 723 for more information.

See Regulations sections 1.721(c)-1(b)(7) and 1.721(c)-3(b) for more information on a gain deferral contribution of section 721(c) property to a section 721(c) partnership. Also see Section 721(c) Partnership, Section 721(c) Property, and Gain Deferral Method under Definitions, earlier.

## **Dispositions of Contributed Property**

Generally, if the partnership disposes of property contributed to the partnership by a partner, income, gain, loss, and deductions from that property must be allocated among the partners to take into account the difference between the property's basis and its FMV at the time of the contribution.

However, if the adjusted basis of the contributed property exceeds its FMV at the time of the contribution, the built-in loss can only be taken into account by the contributing partner. For all other partners, the basis of the property in the hands of the partnership is

treated as equal to its FMV at the time of the contribution (see section 704(c)(1)(C)).

For property contributed to the partnership, the contributing partner must recognize gain or loss on a distribution of the property to another partner within 7 years of being contributed. The gain or loss is equal to the amount that the contributing partner should have recognized if the property had been sold for its FMV when distributed, because of the difference between the property's basis and its FMV at the time of contribution.

See section 704(c) for details and other rules on dispositions of contributed property. See section 724 for the character of any gain or loss recognized on the disposition of unrealized receivables, inventory items, or capital loss property contributed to the partnership by a partner.

See Regulations sections 1.721(c)-4 and 1.721(c)-5 for more information on certain dispositions of contributed 721(c) property to

which the gain deferral method applies. Also see Section 721(c) Partnership, Section 721(c) Property, and Gain Deferral Method under Definitions, earlier.

## **Recognition of Precontribution Gain on Certain Partnership Distributions**

A partner who contributes appreciated property to the partnership must include in income any precontribution gain to the extent the FMV of other property (other than money) distributed to the partner by the partnership exceeds the adjusted basis of the partner's partnership interest just before the distribution. Precontribution gain is the net gain, if any, that would have been recognized under section 704(c)(1)(B) if the partnership had distributed to another partner all the property that had been contributed to the partnership by the distributee partner within 7 years of the distribution and that was held



by the partnership just before the distribution.

Appropriate basis adjustments are to be made to the adjusted basis of the distributee partner's interest in the partnership and the partnership's basis in the contributed property to reflect the gain recognized by the partner.

For more details and exceptions, see Pub. 541.

## **Unrealized Receivables and Inventory Items**

Generally, if a partner sells or exchanges a partnership interest where unrealized receivables or inventory items are involved, the transferor partner must notify the partnership, in writing, within 30 days of the exchange. The partnership must then file Form 8308, Report of a Sale or Exchange of Certain Partnership Interests.

If a partnership distributes unrealized receivables or substantially appreciated inventory items in exchange for all or part of a partner's interest in other partnership property (including money), treat the transaction as a sale or exchange between the partner and the partnership. Treat the partnership gain (loss) as ordinary business income (loss). The income (loss) is specially allocated only to partners other than the distributee partner.

If a partnership gives other property (including money) for all or part of that partner's interest in the partnership's unrealized receivables or substantially appreciated inventory items, treat the transaction as a sale or exchange of the property.

See Rev. Rul. 84-102, 1984-2 C.B. 119, for information on the tax consequences that result when a new partner joins a partnership that has liabilities and unrealized receivables.

Also see Pub. 541 for more information on unrealized receivables and inventory items.

## **At-Risk Limitations**

In general, section 465 limits the amount of deductible losses partners can claim from certain activities. The at-risk limitations don't apply to the partnership, but instead apply to each partner's share of net losses attributable to each activity. Because the treatment of each partner's share of partnership losses depends on the nature of the activity that generated it, the partnership must report the items of income, loss, and deduction separately for each activity. The at-risk limitation applies to individuals, estates, trusts, and certain closely held C corporations. See Pub. 925, *Passive Activity and At-Risk Rules*, for additional information.

**Activities covered by the at-risk rules.** If the partnership is involved in one of the following activities as a trade or business or

for the production of income, the partner may be subject to the at-risk rules.

1. Holding, producing, or distributing motion picture films or videotapes.
2. Farming.
3. Leasing section 1245 property, including personal property and certain other tangible property that's depreciable or amortizable.
4. Exploring for, or exploiting, oil and gas.
5. Exploring for, or exploiting, geothermal deposits (for wells started after September 1978).
6. Any other activity not included in items 1 through 5, above, that's carried on as a trade or business or for the production of income.

**Aggregation of activities.** Activities described in (6) above that constitute a trade or business are treated as one activity if:

- You actively participate in the management of the trade or business, or
- The trade or business is carried on by a partnership or S corporation and 65% or more of its losses for the tax year are allocable to persons who actively participate in the management of the trade or business.

Similar rules apply to activities described in items 1 through 5 above. For more information, see Pub. 925.

If you aggregate your activities under these rules for section 465 purposes, check the appropriate box in item K below the name and address block on page 1 of Form 1065.

**At-risk activity reporting requirements.** If the partnership items of income, loss, or

deduction reported on Schedule K-1 are from more than one activity covered by the at-risk rules, the partnership should report on an attachment to Schedule K-1 information relating to each activity as is required by Item K. Partner's Share of Liabilities, later. See the Instructions for Form 6198 and Pub. 925 for additional information needed to help the partner compute the profit or loss from each at-risk activity and the amount at risk that may be required to be separately reported.

## **Passive Activity Limitations**

In general, section 469 limits the amount of losses, deductions, and credits that partners can claim from passive activities. The passive activity limitations don't apply to the partnership. Instead, they apply to each partner's share of any income or loss and credit attributable to a passive activity.

Because the treatment of each partner's share of partnership income or loss and credit depends on the nature of the activity that

generated it, the partnership must report income or loss and credits separately for each activity.

The following instructions and the instructions for Schedules K and K-1, later, explain the applicable passive activity limitation rules and specify the type of information the partnership must provide to its partners for each activity. If the partnership had more than one activity, it must report information for each activity on an attached statement to Schedules K and K-1.

Generally, passive activities include (a) activities that involve the conduct of a trade or business if the partner doesn't materially participate in the activity, and (b) all rental activities (defined later) regardless of the partner's participation. For exceptions, see *Activities That Are Not Passive Activities*, later. The level of each partner's participation in an activity must be determined by the partner.

The passive activity rules provide that losses and credits from passive activities can generally be applied only against income and tax from passive activities. Thus, passive losses and credits can't be applied against income from salaries, wages, professional fees, or a business in which the partner materially participates; against portfolio income (defined later); or against the tax related to any of these types of income.

Special provisions apply to certain activities. First, the passive activity limitations must be applied separately for a net loss from passive activities held through a PTP. Second, special rules require that net income from certain activities that would otherwise be treated as passive income must be recharacterized as nonpassive income for purposes of the passive activity limitations.

To allow each partner to correctly apply the passive activity limitations, the partnership must report income or loss and credits



separately by activity for each of the following.

- Trade or business activities.
- Rental real estate activities.
- Rental activities other than real estate.
- Portfolio income.

## **Activities That Aren't Passive Activities**

The following aren't passive activities.

1. Trade or business activities in which the partner materially participated for the tax year.
2. Any rental real estate activity in which the partner materially participated if the partner met both of the following conditions for the tax year.
  - a. More than half of the personal services the partner performed in trades or businesses were

performed in real property trades or businesses in which the partner materially participated.

- b. The partner performed more than 750 hours of services in real property trades or businesses in which the partner materially participated.

**Note.** For a partner that is a closely held C corporation (defined in section 465(a)(1)(B)), the above conditions are treated as met if more than 50% of the corporation's gross receipts are from real property trades or businesses in which the corporation materially participated.

For purposes of this rule, each interest in rental real estate is a separate activity, unless the partner elects to treat all interests in rental real estate as one activity.

If the partner is married filing jointly, either the partner or the partner's spouse must separately meet both of the above conditions, without taking into account services performed by the other spouse.

A real property trade or business is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Services the partner performed as an employee aren't treated as performed in a real property trade or business unless the partner owned more than 5% of the stock (or more than 5% of the capital or profits interest) in the employer.

3. An interest in an oil or gas well drilled or operated under a working interest if at any time during the tax year the

partner held the working interest directly or through an entity that didn't limit the partner's liability (for example, an interest as a general partner). This exception applies regardless of whether the partner materially participated for the tax year.

4. The rental of a dwelling unit used by a partner for personal purposes during the year for more than the greater of 14 days or 10% of the number of days that the residence was rented at fair rental value.
5. An activity of trading personal property for the account of owners of interests in the activity. For purposes of this rule, personal property means property that is actively traded, such as stocks, bonds, and other securities. See Temporary Regulations section 1.469-1T(e)(6).

## **Trade or Business Activities**

A trade or business activity is an activity (other than a rental activity or an activity treated as incidental to an activity of holding property for investment) that:

- Involves the conduct of a trade or business (within the meaning of section 162),
- Is conducted in anticipation of starting a trade or business, or
- Involves research or experimental expenditures deductible under section 174 (or that would be if you chose to deduct rather than capitalize them).

If the partner doesn't materially participate in the activity, a trade or business activity conducted through a partnership is generally a passive activity of the partner.

Each partner must determine if the partner materially participated in an activity. As a

result, while the partnership's ordinary business income (loss) is reported on page 1 of Form 1065, the specific income and deductions from each separate trade or business activity must be reported on attached statements to Form 1065. Similarly, while each partner's distributive share of the partnership's ordinary business income (loss) is reported in box 1 of Schedule K-1, each partner's distributive share of the income and deductions from each trade or business activity must be reported on attached statements to each Schedule K-1. See Passive Activity Reporting Requirements, later, for more information.

## **Rental Activities**

Generally, except as noted below, if the gross income from an activity consists of amounts paid principally for the use of real or personal tangible property held by the partnership, the activity is a rental activity.

There are several exceptions to this general rule. Under these exceptions, an activity involving the use of real or personal tangible property isn't a rental activity if any of the following apply.

The average period of customer use (defined below) for such property is 7 days or less.

- The average period of customer use for such property is 30 days or less and significant personal services (defined below) are provided by or on behalf of the partnership.
- Extraordinary personal services (defined below) are provided by or on behalf of the partnership.
- The rental of such property is treated as incidental to a nonrental activity of the partnership under Temporary Regulations section 1.469-1T(e)(3)(vi) and Regulations section 1.469-1(e)(3)(vi)(D).

- The partnership customarily makes the property available during defined business hours for nonexclusive use by various customers.
- The partnership provides property for use in a nonrental activity of a partnership or joint venture in its capacity as an owner of an interest in such partnership or joint venture. Whether the partnership provides property used in an activity of another partnership or of a joint venture in the partnership's capacity as an owner of an interest in the partnership or joint venture is determined on the basis of all the facts and circumstances.

In addition, a guaranteed payment described in section 707(c) is never income from a rental activity.

**Average period of customer use.** Figure the average period of customer use for a class of property by dividing the total number



of days in all rental periods by the number of rentals during the tax year. If the activity involves renting more than one class of property, multiply the average period of customer use of each class by the ratio of the gross rental income from that class to the activity's total gross rental income. The activity's average period of customer use equals the sum of these class-by-class average periods weighted by gross income. See Regulations section 1.469-1(e)(3)(iii).

**Significant personal services.** Personal services include only services performed by individuals. To determine if personal services are significant personal services, consider all the relevant facts and circumstances.

Relevant facts and circumstances include:

- How often the services are provided,
- The type and amount of labor required to perform the services, and

- The value of the services in relation to the amount charged for use of the property.

The following services aren't considered in determining whether personal services are significant.

- Services necessary to permit the lawful use of the rental property.
- Services performed in connection with improvements or repairs to the rental property that extend the useful life of the property substantially beyond the average rental period.
- Services provided in connection with the use of any improved real property that are similar to those commonly provided in connection with long-term rentals of high-grade commercial or residential property. Examples include cleaning and maintenance of common areas, routine repairs, trash collection,

elevator service, and security at entrances.

**Extraordinary personal services.** Services provided in connection with making rental property available for customer use are extraordinary personal services only if the services are performed by individuals and the customers' use of the rental property is incidental to their receipt of the services.

For example, a patient's use of a hospital room is generally incidental to the care received from the hospital's medical staff. Similarly, a student's use of a dormitory room in a boarding school is incidental to the personal services provided by the school's teaching staff.

**Rental activity incidental to a nonrental activity.** An activity isn't a rental activity if the rental of the property is incidental to a nonrental activity, such as the activity of holding property for investment, a trade or

business activity, or the activity of dealing in property.

Rental of property is incidental to an activity of holding property for investment if both of the following apply.

- The main purpose for holding the property is to realize a gain from the appreciation of the property.
- The gross rental income from such property for the tax year is less than 2% of the smaller of the property's unadjusted basis or its FMV.

Rental of property is incidental to a trade or business activity if all of the following apply.

- The partnership owns an interest in the trade or business at all times during the year.
- The rental property was mainly used in the trade or business activity during

the tax year or during at least 2 of the 5 preceding tax years.

- The gross rental income from the property for the tax year is less than 2% of the smaller of the property's unadjusted basis or its FMV.

The sale or exchange of property that is also rented during the tax year (in which the gain or loss is recognized) is treated as incidental to the activity of dealing in property if, at the time of the sale or exchange, the property was held primarily for sale to customers in the ordinary course of the partnership's trade or business.

See Temporary Regulations section 1.469-1T(e)(3) and Regulations section 1.469-1(e)(3) for more information on the definition of rental activities for purposes of the passive activity limitations.

**Reporting of rental activities.** In reporting the partnership's income or losses and credits

from rental activities, the partnership must separately report rental real estate activities and rental activities other than rental real estate activities.

Partners who actively participate in a rental real estate activity may be able to deduct part or all of their rental real estate losses (and the deduction equivalent of rental real estate credits) against income (or tax) from nonpassive activities. The combined amount of rental real estate losses and the deduction equivalent of rental real estate credits from all sources (including rental real estate activities not held through the partnership) that may be claimed is limited to \$25,000. This \$25,000 amount is generally reduced for high-income partners.

Report rental real estate activity income (loss) on Form 8825 and Schedule K, line 2, and in box 2 of Schedule K-1, rather than on page 1 of Form 1065. Report credits related to rental real estate activities on Schedule K,

lines 15c and 15d (box 15, codes E and F, of Schedule K-1), and low-income housing credits on Schedule K, lines 15a and 15b (box 15, codes C and D, of Schedule K-1).

See Line 3. Other Net Rental Income (Loss), later, for reporting other net rental income (loss) other than rental real estate.

## **Portfolio Income**

Generally, portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business, that is attributable to interest; dividends; royalties; income from a real estate investment trust (REIT), a regulated investment company (RIC), a REMIC, a common trust fund, a CFC, a QEF, or a cooperative; income from the disposition of property that produces income of a type defined as portfolio income; and income from the disposition of property held for investment. See Self-Charged Interest, later, for an exception.

Solely for purposes of the preceding paragraph, gross income derived in the ordinary course of a trade or business includes (and portfolio income, therefore, doesn't include) the following types of income.

- Interest income on loans and investments made in the ordinary course of a trade or business of lending money.
- Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business.
- Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity



contracts or reinsuring risks  
underwritten by insurance companies.

- Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (unless the dealer held the property for investment at any time before such income or gain is recognized).
- Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property.
- Amounts included in the gross income of a patron of a cooperative by reason of any payment or allocation to the patron based on patronage as a result of a trade or business of the patron.
- Other income identified by the IRS as income derived by the taxpayer in the ordinary course of a trade or business.

See Temporary Regulations section 1.469-2T(c)(3) for more information on portfolio income.

Report portfolio income and related deductions on Schedule K rather than on page 1 of Form 1065.

## **Self-Charged Interest**

Certain self-charged interest income and deductions may be treated as passive activity gross income and passive activity deductions if the loan proceeds are used in a passive activity. Generally, self-charged interest income and deductions result from loans between the partnership and its partners and also includes loans between the partnership and another partnership if each owner in the borrowing entity has the same proportional ownership interest in the lending entity.

The self-charged interest rules don't apply to a partner's interest in a partnership if the partnership makes an election under

Regulations section 1.469-7(g) to avoid the application of these rules. To make the election, the partnership must attach to its original or amended partnership return a statement that includes the name, address, and EIN of the partnership and a declaration that the election is being made under Regulations section 1.469-7(g). The election will apply to the tax year in which it was made and all subsequent tax years. Once made, the election may only be revoked with the consent of the IRS.

For more details on the self-charged interest rules, see Regulations section 1.469-7.

## **Grouping Activities**

Generally, one or more trade or business or rental activities may be treated as a single activity if the activities make up an appropriate economic unit for measurement of gain or loss under the passive activity rules. Whether activities make up an

appropriate economic unit depends on all the relevant facts and circumstances. The factors given the greatest weight in determining whether activities make up an appropriate economic unit are:

- Similarities and differences in types of trades or businesses,
- The extent of common control,
- The extent of common ownership,
- Geographical location, and
- Reliance between or among the activities.

***Example.*** The partnership has a significant ownership interest in a bakery and a movie theater in Baltimore and a bakery and a movie theater in Philadelphia. Depending on the relevant facts and circumstances, there may be more than one reasonable method for grouping the partnership's activities. For

instance, the following groupings may or may not be permissible.

- A single activity.
- A movie theater activity and a bakery activity.
- A Baltimore activity and a Philadelphia activity.
- Four separate activities.

Once the partnership chooses a grouping under these rules, it must continue using that grouping in later tax years unless a material change in the facts and circumstances makes it clearly inappropriate.

The IRS may regroup the partnership's activities if the partnership's grouping fails to reflect one or more appropriate economic units and one of the primary purposes of the grouping is to avoid the passive activity limitations.

## **Limitation on grouping certain activities.**

The following activities may not be grouped together.

1. A rental activity with a trade or business activity unless the activities being grouped together make up an appropriate economic unit and:
  - a. The rental activity is insubstantial relative to the trade or business activity or vice versa, or
  - b. Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity. If so, the portion of the rental activity involving the rental of property to be used in the trade or business activity can be grouped with the trade or business activity.
2. An activity involving the rental of real property with an activity involving the

rental of personal property (except personal property provided in connection with the real property or vice versa).

3. Any activity with another activity in a different type of business and in which the partnership holds an interest as a limited partner or as a limited entrepreneur (as defined in section 461(k)(4)) if that other activity engages in holding, producing, or distributing motion picture films or videotapes; farming; leasing section 1245 property; or exploring for or exploiting oil and gas resources or geothermal deposits.

**Activities conducted through other partnerships.** Once a partnership determines its activities under these rules, the partnership as a partner can use these rules to group those activities with:

- Each other,

- Activities conducted directly by the partnership, or
- Activities conducted through other partnerships.

A partner can't treat as separate activities those activities grouped together by a partnership.

If you group your activities under these rules for section 469 purposes, check the appropriate box in item K below the name and address block on page 1 of Form 1065.

## **Recharacterization of Passive Income**

Under Temporary Regulations section 1.469-2T(f) and Regulations section 1.469-2(f), net passive income from certain passive activities must be treated as nonpassive income. Net passive income is the excess of an activity's passive activity gross income over its passive activity deductions (current year deductions and prior year unallowed losses).



Any net passive income recharacterized as nonpassive income is treated as investment income for purposes of figuring investment interest expense limitations if it's from (a) an activity of renting substantially nondepreciable property from an equity-financed lending activity, or (b) an activity related to an interest in a pass-through entity that licenses intangible property.

The amount of income from the activities in the first three paragraphs, below, that any partner will be required to recharacterize as nonpassive income may be limited under Temporary Regulations section 1.469-2T(f)(8). Because the partnership won't have information regarding all of a partner's activities, it must identify all partnership activities meeting the definitions under *Certain nondepreciable rental property activities* and *Passive equity-financed lending activities* below as activities that may be subject to recharacterization.

Income from the following six sources is subject to recharacterization.

**Significant participation passive**

**activities.** A significant participation passive activity is any trade or business activity in which the partner participated for more than 100 hours during the tax year but didn't materially participate. Because each partner must determine the partner's level of participation, the partnership won't be able to identify significant participation passive activities.

**Certain nondepreciable rental property**

**activities.** Net passive income from a rental activity is nonpassive income if less than 30% of the unadjusted basis of the property used or held for use by customers in the activity is subject to depreciation under section 167.

**Passive equity-financed lending**

**activities.** If the partnership has net income from a passive equity-financed lending activity, the smaller of the net passive income

or the equity-financed interest income from the activity is nonpassive income.

**Rental of property incidental to a development activity.** Net rental activity income is the excess of passive activity gross income from renting or disposing of property over passive activity deductions (current year deductions and prior year unallowed losses) that are reasonably allocable to the rented property. Net rental activity income is nonpassive income for a partner if all of the following apply.

- The partnership recognizes gain from the sale, exchange, or other disposition of the rental property during the tax year.
- The use of the item of property in the rental activity started less than 12 months before the date of disposition. The use of an item of rental property begins on the first day that (a) the partnership owns an interest in the

property, (b) substantially all of the property is either rented or held out for rent and ready to be rented, and (c) no significant value-enhancing services remain to be performed.

- The partner materially or significantly participated for any tax year in an activity that involved performing services to enhance the value of the property (or any other item of property if the basis of the property disposed of is determined in whole or in part by reference to the basis of that item of property).

Because the partnership can't determine a partner's level of participation, the partnership must identify net income from property described earlier under *Rental Activities* (without regard to the partner's level of participation) as income that may be subject to recharacterization.

**Rental of property to a nonpassive activity.** If a taxpayer rents property to a trade or business activity in which the taxpayer materially participates, the taxpayer's net rental activity income from the property is nonpassive income.

**Acquisition of an interest in a pass-through entity that licenses intangible property.** Generally, net royalty income from intangible property is nonpassive income if the taxpayer acquired an interest in the pass-through entity after the pass-through entity created the intangible property or performed substantial services or incurred substantial costs in developing or marketing the intangible property. Net royalty income is the excess of passive activity gross income from licensing or transferring any right in intangible property over passive activity deductions (current year deductions and prior year unallowed losses) that are reasonably allocable to the intangible property.

See Temporary Regulations section 1.469-2T(f)(7)(iii) for exceptions to this rule.

## **Passive Activity Reporting Requirements**

To allow partners to correctly apply the passive activity loss and credit limitation rules, the partnership must do the following.

1. If the partnership carries on more than one activity, provide an attached statement for each activity conducted through the partnership that identifies the type of activity conducted (trade or business, rental real estate, or rental activity other than rental real estate). See Grouping Activities, earlier.
2. On the attached statement for each activity, provide a statement, using the same box numbers as shown on Schedule K-1, detailing the net income (loss), credits, and all items required

to be separately stated under section 702(a) from each trade or business activity, from each rental real estate activity, from each rental activity other than a rental real estate activity, and from investments. If the partnership grouped separate activities, the attachments must identify each group. The attached group activity description must be sufficient for a partner to determine if its other activities qualify to be grouped with any groups provided by the partnership.

3. Identify the net income (loss) and credits from each oil or gas well drilled or operated under a working interest that any partner (other than a partner whose only interest in the partnership during the year is as a limited partner) holds through the partnership. Further, if any partner had an interest as a general partner in the partnership

during less than the entire year, the partnership must identify both the disqualified deductions from each well that the partner must treat as passive activity deductions, and the ratable portion of the gross income from each well that the partner must treat as passive activity gross income.

4. Identify the net income (loss) and the partner's share of partnership interest expense from each activity of renting a dwelling unit that any partner uses for personal purposes during the year for more than the greater of 14 days or 10% of the number of days that the residence is rented at fair rental value.
5. Identify the net income (loss) and the partner's share of partnership interest expense from each activity of trading personal property conducted through the partnership.



6. For any gain (loss) from the disposition of an interest in an activity or of an interest in property used in an activity (including dispositions before 1987 from which gain is being recognized after 1986):
  - a. Identify the activity in which the property was used at the time of disposition;
  - b. If the property was used in more than one activity during the 12 months preceding the disposition, identify the activities in which the property was used and the adjusted basis allocated to each activity; and
  - c. For gains only, if the property was substantially appreciated at the time of the disposition and the applicable holding period specified in Regulations section 1.469-2(c)(2)(iii)(A) wasn't satisfied,

identify the amount of the nonpassive gain and indicate whether the gain is investment income under Regulations section 1.469-2(c)(2)(iii)(F).

7. Specify the amount of gross portfolio income, the interest expense properly allocable to portfolio income, and expenses other than interest expense that are clearly and directly allocable to portfolio income.
8. Identify separately any of the following types of payments to partners.
  - a. Payments to a partner for services other than in the partner's capacity as a partner under section 707(a).
  - b. Guaranteed payments to a partner for services under section 707(c).
  - c. Guaranteed payments for use of capital.

- d. If section 736(a)(2) payments are made for unrealized receivables or for goodwill, the amount of the payments and the activities to which the payments are attributable.
  - e. If section 736(b) payments are made, the amount of the payments and the activities to which the payments are attributable.
- 9. Identify the ratable portion of any section 481 adjustment (whether a net positive or a net negative adjustment) allocable to each partnership activity.
  - 10. Identify the amount of gross income from each oil or gas property of the partnership.
  - 11. Identify any gross income from sources specifically excluded from passive activity gross income, including:

- a. Income from intangible property if the partner is an individual whose personal efforts significantly contributed to the creation of the property;
  - b. Income from state, local, or foreign income tax refunds; and
  - c. Income from a covenant not to compete if the partner is an individual who contributed the covenant to the partnership.
12. Identify any deductions that aren't passive activity deductions.
13. If the partnership makes a full or partial disposition of its interest in another entity, identify the gain (loss) allocable to each activity conducted through the entity, and the gain allocable to a passive activity that would have been recharacterized as nonpassive gain had the partnership

disposed of its interest in property used in the activity (because the property was substantially appreciated at the time of the disposition, and the gain represented more than 10% of the partner's total gain from the disposition).

14. Identify the following items from activities that may be subject to the recharacterization rules. See *Recharacterization of Passive Income*, earlier.
- a. Net income from an activity of renting substantially nondepreciable property.
  - b. The smaller of equity-financed interest income or net passive income from an equity-financed lending activity.
  - c. Net rental activity income from property developed (by the partner

or the partnership), rented, and sold within 12 months after the rental of the property commenced.

- d. Net rental activity income from the rental of property by the partnership to a trade or business activity in which the partner had an interest (either directly or indirectly).
- e. Net royalty income from intangible property if the partner acquired the partner's interest in the partnership after the partnership created the intangible property or performed substantial services, or incurred substantial costs in developing or marketing the intangible property.

15. Identify separately the credits from each activity conducted by or through the partnership.

16. Identify the partner's distributive share of the partnership's self-charged interest income or expense (see Self-Charged Interest, earlier).
- a. Loans between a partner and the partnership. Identify the lending or borrowing partner's share of the self-charged interest income or expense. If the partner made the loan to the partnership, also identify the activity in which the loan proceeds were used. If the proceeds were used in more than one activity, allocate the interest to each activity based on the amount of the proceeds used in each activity.
  - b. Loans between the partnership and another partnership or S corporation. If the partnership's partners have the same proportional ownership interest in

the partnership and the other partnership or S corporation, identify each partner's share of the interest income or expense from the loan. If the partnership was the borrower, also identify the activity in which the loan proceeds were used. If the loan proceeds were used in more than one activity, allocate the interest to each activity based on the amount of the proceeds used in each activity.

## **Net Investment Income Tax Reporting Requirements**

The information described in this section should be given directly to the partner and shouldn't be reported by the partnership to the IRS.

To allow partners to correctly figure the net investment income tax (NIIT) where a partner disposes of an interest in the partnership



during the tax year, the partnership may be required to provide the partner with certain information. The NIIT is a tax imposed on an individual's, trust's, or estate's net investment income. Net investment income includes the net gains or losses from the sale of an interest in the partnership. A partner who is actively involved in one or more of the partnership's or lower-tier pass-through entities' trades or businesses (other than trading in financial instruments or commodities) can reduce the amount of the gain or loss from the sale of the partnership or lower-tier pass-through entity interest included in its net investment income. However, to figure its net investment income, the active partner needs certain information from the partnership.

Generally, the partnership must provide certain information to the partner if the partnership knows, or has reason to know, the following.

- The partner disposed of an interest in the partnership.
- The partner materially participates (within the meaning of the passive activity loss rules (section 469)) in one or more of the trades or businesses (within the meaning of section 162) of the partnership or a lower-tier pass-through entity (other than trading in financial instruments or commodities).
- The partner doesn't qualify for the optional simplified reporting method for figuring its net investment income associated with the disposition of the interest. For more information, see the instructions for Form 8960, line 5c.

**Information to be provided to partner.**

Generally, the partnership must provide the partner with its distributive share of the net gain and loss from the deemed sale for FMV of the partnership's property, other than property that relates to the trades or

businesses in which the partner materially participates, as determined under the passive activity loss rules applicable to the transfer of an interest in a pass-through entity. For more information, see the instructions for Form 8960, line 5c.

If a partner, who qualifies for the optional simplified reporting method, prefers to determine net gain or loss under the general calculation, the partnership may, but isn't obligated to, provide the information to the partner at that partner's request.

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# **Specific Instructions**

These instructions follow the line numbers on the first page of Form 1065. The accompanying schedules are discussed separately. Specific instructions for most of the lines are provided. Lines that aren't discussed are self-explanatory.

Fill in all applicable lines and schedules.

Enter any items specially allocated to the partners in the appropriate box of the applicable partner's Schedule K-1. Enter the total amount on the appropriate line of Schedule K. Don't enter separately stated amounts on the numbered lines on Form 1065; Form 1125-A, page 1; or Schedule D (Form 1065).

File all six pages of Form 1065. However, if the answer to Schedule B, question 4, is "Yes," Schedules L, M-1, and M-2 on page 6 are optional. Also attach a Schedule K-1 to Form 1065 for each partner.

File only one Form 1065 for each partnership. Mark "Duplicate Copy" on any copy you give to a partner.

If a syndicate, pool, joint venture, or similar group files Form 1065, it must attach a copy of the agreement and all amendments to the return, unless a copy has previously been filed.



*A foreign partnership required to file a return must generally report all of its foreign and U.S. partnership items.*

*For rules regarding whether a foreign partnership must file Form 1065, see Who Must File, earlier.*

## **Name and Address**

Enter the legal name of the partnership, address, and EIN on the appropriate lines. If the partnership has changed its name, check box G(3). Include the suite, room, or other unit number after the street address. If the post office doesn't deliver mail to the street

address and the partnership has a P.O. box, show the box number instead.

If the partnership receives its mail in care of a third party (such as an accountant or an attorney), enter "C/O" on the street address line, followed by the third party's name and street address or P.O. box.

If the partnership's address is outside the United States or U.S. territories, enter the information on the line for "City or town, state or province, country, and ZIP or foreign postal code" in the following order: city, province or state, and the foreign country. Follow the foreign country's practice in placing the postal code in the address. Don't abbreviate the country name.

If the partnership has changed its address since it last filed a return (including a change to an "in care of" address), check box G(4) for "Address change."



*If the partnership changes its mailing address or the responsible party after filing its return, it can notify the IRS by filing Form 8822-B, Change of Address or Responsible Party—Business.*

## **Partnerships With Adjustments in the Current Year That Didn't Result in an IU**

If a partnership has an adjustment from a BBA audit which doesn't result in an IU, the partnership shouldn't take the adjustment into account until the adjustment year (see Definitions, earlier). With its Form 1065 for the adjustment year, the partnership should provide a statement describing the adjustments, including the line numbers to which the adjustments relate, and incorporate those adjustments into its adjustment year return. If there's a reallocation adjustment being reported on the adjustment year return, ensure the statement identifies the partner receiving the reallocation adjustment.



If there's an adjustment to a separately stated item or to a credit, the partnership must adjust that item or that credit in the adjustment year. See Examples 1 and 2 in Regulations 301.6225-3.

## **Items A and C**

Enter the applicable activity name and the code number from the list, *Codes for Principal Business Activity and Principal Product or Service*, near the end of these instructions.

For example, if, as its principal business activity, the partnership (a) purchases raw materials, (b) subcontracts out for labor to make a finished product from the raw materials, and (c) retains title to the goods, the partnership is considered to be a manufacturer and must enter "Manufacturer" in item A and enter in item C one of the codes (311110 through 339900) listed under "Manufacturing" on the list, *Codes for Principal Business Activity and Principal*

*Product or Service*, near the end of these instructions. For nonstore retailers, select the Principal Business Activity (PBA) code by the primary product that your establishment sells. For example, establishments primarily selling prescription and non-prescription drugs, select PBA code 456110 Pharmacies & Drug Retailers.

## **Item D. Employer Identification Number (EIN)**

Show the correct EIN in item D. If the partnership doesn't have an EIN, it must apply for one in one of the following ways.

- Online—Go to [IRS.gov/EIN](https://www.irs.gov/ein). The EIN is issued immediately once the application information is validated.
- By mailing or faxing Form SS-4, Application for Employer Identification Number.

An LLC must determine which type of federal tax entity it will be (partnership, corporation, or disregarded entity (DE)) before applying for an EIN (see Form 8832 for details). If the partnership hasn't received its EIN by the time the return is due, enter "Applied for" and the application date in the space for the EIN. For more details, see the Instructions for Form SS-4.

**Note.** The online application process isn't yet available for partnerships with addresses in foreign countries. If you're located outside the United States, please call 267-941-1099.

## **Item F. Total Assets**

You aren't required to complete item F if the answer to Schedule B, question 4, is "Yes."

If you're required to complete this item, enter the partnership's total assets at the end of the tax year, as determined by the accounting method regularly used in keeping the partnership's books and records. If there were

no assets at the end of the tax year, enter zero.

## **Item J. Schedule C and Schedule M-3**

A partnership must file Schedule M-3, Net Income (Loss) Reconciliation for Certain Partnerships, instead of Schedule M-1, if any of the following apply.

- The amount of total assets at the end of the tax year reported on Schedule L, line 14, column (d), is \$10 million or more.
- The amount of adjusted total assets for the tax year is \$10 million or more. Adjusted total assets is defined in the Instructions for Schedule M-3.
- The amount of total receipts (as defined later in the instructions for Schedule B, question 4) for the tax year is \$35 million or more.

- An entity that is a reportable entity partner of the partnership owns or is deemed to own, directly or indirectly, an interest of 50% or more in the partnership's capital, profit, or loss on any day during the tax year of the partnership. Reportable entity partner is defined in the Instructions for Schedule M-3.

A partnership filing Form 1065 that isn't required to file Schedule M-3 may voluntarily file Schedule M-3 instead of Schedule M-1.

Any partnership that files Schedule M-3 must also complete and file Schedule C (Form 1065), Additional Information for Schedule M-3 Filers. See *Eased requirements* next.

***Eased requirements.*** Partnerships that (a) are required to file Schedule M-3 and have less than \$50 million in total assets at tax-year-end, or (b) aren't required to file Schedule M-3 and voluntarily file Schedule M-3, must either (i) complete Schedule M-3

entirely, or (ii) complete Schedule M-3 through Part I and complete Schedule M-1 instead of completing Parts II and III of Schedule M-3.

In addition, partnerships that meet the requirements of (a) and (b) above aren't required to file Schedule C (Form 1065) or Form 8916-A.

See the instructions for Schedule C and Schedule M-3 for more information.

# Income



*Report only trade or business activity income on lines 1a through 8. Don't report rental activity income or portfolio income on these lines. See Passive Activity Limitations, earlier, for definitions of rental activity income and portfolio income. Rental activity income and portfolio income are reported on Schedules K and K-1. Rental real estate activities are also reported on Form 8825.*

**Tax-exempt income.** Don't include any tax-exempt income on lines 1a through 8. A partnership that receives any tax-exempt income other than interest, or holds any property or engages in any activity that produces tax-exempt income, reports this income on Schedule K, line 18b, and in box 18 of Schedule K-1 using code B.

Report tax-exempt interest income, including exempt-interest dividends received as a

shareholder in a mutual fund or other RIC, on Schedule K, line 18a, and in box 18 of Schedule K-1 using code A.

See *Deductions*, later, for information on how to report expenses related to tax-exempt income.

## **Line 1a. Gross Receipts or Sales**

Enter on line 1a gross receipts or sales from all trade or business operations, except for amounts that must be reported on lines 4 through 7. If a cost offset method under section 451(b) or (c) is used, the resulting gross income is reported on line 1a.

Special rules apply to certain income, as discussed below. For example, don't include gross receipts from farming on line 1a. Instead, show the net profit (loss) from farming on line 5. Also, don't include on line 1a rental activity income or portfolio income.

In general, advance payments are reported in the year of receipt. For exceptions to this



general rule for partnerships that use the accrual method of accounting, see the following.

- To report income from long-term contracts, see section 460.
- For permissible methods that allow a limited deferral of advance payments beyond the current tax year, see section 451(c) and Regulations section 1.451-8.
- For information on adopting or changing to a permissible method for reporting advance payment for goods and services by an accrual method partnership, see the Instructions for Form 3115.

**Installment sales.** Generally, the installment method can't be used for dealer dispositions of property. A dealer disposition is any disposition of:

- Personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan, or
- Real property held for sale to customers in the ordinary course of the taxpayer's trade or business.

***Exception.*** These restrictions on using the installment method don't apply to dispositions of property used or produced in a farming business or sales of timeshares and residential lots. However, if the partnership elects to report dealer dispositions of timeshares and residential lots on the installment method, each partner's tax liability must be increased by the partner's distributive share of the interest payable under section 453(l)(3).

Include on line 1a the gross profit on collections from installment sales for any of the following.

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

Attach a statement showing the following information for the current year and the 3 preceding years.

- Gross sales.
- Cost of goods sold.
- Gross profits.
- Percentage of gross profits to gross sales.
- Amount collected.
- Gross profit on the amount collected.

### **Nonaccrual-experience method.**

Partnerships that qualify to use the nonaccrual-experience method (described earlier) should attach a statement showing total gross receipts, the amount not accrued as a result of the application of section 448(d)(5), and the net amount accrued. Include the net amount on line 1a.

### **Line 2. Cost of Goods Sold**

If the partnership has a cost of goods sold deduction, complete and attach Form 1125-A. Enter on Form 1065, page 1, line 2, the amount from Form 1125-A, line 8. See Form 1125-A and its instructions.

### **Line 4. Ordinary Income (Loss) From Other Partnerships, Estates, and Trusts**

Enter the ordinary income (loss) shown on Schedule K-1 (Form 1065) or Schedule K-1 (Form 1041), or other ordinary income (loss) from a foreign partnership, estate, or trust.

Show the partnership's, estate's, or trust's name, address, and EIN on a separate statement attached to this return. If the amount entered is from more than one source, identify the amount from each source.

Don't include portfolio income or rental activity income (loss) from other partnerships, estates, or trusts on this line. Instead, report these amounts on Schedules K and K-1, or on Form 8825, line 20a, if the amount is from a rental real estate activity.

Ordinary income (loss) from another partnership that is a PTP isn't reported on this line. Instead, report the amount separately on Schedule K, line 11, and in box 11 of Schedule K-1 using code ZZ.

Treat shares of other items separately reported on Schedule K-1 issued by the other entity as if the items were realized or incurred by this partnership.

If there's a loss from another partnership, the amount of the loss that may be claimed is subject to the basis limitations as appropriate.

If the tax year of your partnership doesn't coincide with the tax year of the other partnership, estate, or trust, include the ordinary income (loss) from the other entity in the tax year in which the other entity's tax year ends.

## **Line 5. Net Farm Profit (Loss)**

Enter the partnership's net farm profit (loss) from Schedule F (Form 1040). Attach Schedule F (Form 1040) to Form 1065. Don't include on this line any farm profit (loss) from other partnerships. Report those amounts on line 4. In figuring the partnership's net farm profit (loss), don't include any section 179 expense deduction; this amount must be separately stated.

Also report the partnership's fishing income on this line.

For a special rule concerning the method of accounting for a farming partnership with a corporate partner and for other tax information on farms, see Pub. 225, Farmer's Tax Guide.



*Because the partner, and not the partnership, makes the election to deduct the expenses of raising any plant with a preproductive period of more than 2 years, farm partnerships that aren't required to use an accrual method shouldn't capitalize such expenses. Instead, state them separately on an attached statement to Schedule K, line 13d, and in box 13 of Schedule K-1 using code P. See section 263A(d) for more information.*

## Line 6. Net Gain (Loss) From Form 4797



*Include only ordinary gains or losses from the sale, exchange, or involuntary conversion of assets used in a trade or business activity. Ordinary gains or losses from the sale, exchange, or involuntary conversion of rental activity assets are reported separately on Form 8825, line 19, or Schedule K, line 3c, and in box 3 of Schedule K-1, generally as a part of the net income (loss) from the rental activity.*

A partnership that is a partner in another partnership must include on Form 4797 its share of ordinary gains (losses) from sales, exchanges, or involuntary conversions (other than casualties or thefts) of the other partnership's trade or business assets.

Partnerships shouldn't use Form 4797 to report the sale or other disposition of property if a section 179 expense deduction



was previously passed through to any of its partners for that property. Instead, report it in box 20 of Schedule K-1 using code L. See *Dispositions of property with section 179 deductions (code L)*, later, for details.

## **Line 7. Other Income (Loss)**

Enter any other trade or business income (loss) not included on lines 1a through 6. List the type and amount of income on an attached statement. Examples of other income include the following.

- Interest income derived in the ordinary course of the partnership's trade or business, such as interest charged on receivable balances.
- Recoveries of bad debts deducted in prior years under the specific charge-off method.
- Taxable income from insurance proceeds.

- Any amount included in income from Form 6478, Biofuel Producer Credit, line 2, if applicable.
- Any amount included in income from Form 8864, line 9, if applicable.
- The recapture amount under section 280F if the business use of listed property drops to 50% or less. To figure the recapture amount, complete Form 4797, Part IV.
- All section 481 income adjustments resulting from changes in accounting methods. Show the computation of the section 481 adjustments on an attached statement.
- Part or all of the proceeds received from certain employer-owned life insurance contracts issued after August 17, 2006. Partnerships that own one or more employer-owned life insurance contracts issued after that

date must file Form 8925, Report of Employer-Owned Life Insurance Contracts. See section 101(j) for details.

- The amount of payroll tax credit taken by an employer for qualified paid sick leave and qualified paid family leave under the Families First Coronavirus Response Act (FFCRA) and the American Rescue Plan Act of 2021 (the ARP). See Form 941, lines 11b, 11d, 13c, and 13e; Form 944, lines 8b, 8d, 10d, and 10f; or Form 943, lines 12b, 12d, 14d, and 14f. The partnership must include the full amount (both the refundable and nonrefundable portions) of the credit for qualified sick and family leave wages in its gross income for the tax year that includes the last day of any calendar quarter with respect to which a credit is allowed.

**Note.** A credit is available only if the leave was taken sometime after March 31, 2020, and before October 1, 2021, and only after the qualified leave wages were paid, which might under certain circumstances not occur until a quarter after September 30, 2021, including quarters during 2022. Accordingly, all lines related to qualified sick and family leave wages remain on the employment tax returns for 2023.

- The amount of any COBRA premium assistance credit allowed to employers under section 6432(e), as amended by the ARP. See Notices 2021-31 and 2021-46.

Don't include items requiring separate computations that must be reported on Schedules K and K-1. See the instructions for Schedules K and K-1, later.

Don't report portfolio or rental activity income (loss) on this line.

# Deductions

*Report only trade or business activity deductions on lines 9 through 21.* Don't report the following expenses on lines 9 through 21.

- Rental activity expenses. Report these expenses on Form 8825 or Schedule K, line 3b.
- Deductions allocable to portfolio income. Report these deductions on Schedule K, line 13e, and in box 13 of Schedule K-1 using code I or L.
- Nondeductible expenses (for example, expenses connected with the production of tax-exempt income). Report nondeductible expenses on Schedule K, line 18c, and in box 18 of Schedule K-1 using code C.
- Qualified expenditures to which an election under section 59(e) may apply. The instructions for Schedule K,

line 13d, and for box 13, code J, of Schedule K-1 explain how to report these amounts.

- Items the partnership must state separately that require separate computations by the partners. Examples include expenses incurred for the production of income instead of in a trade or business, charitable contributions, foreign taxes paid or accrued, intangible drilling and development costs, soil and water conservation expenditures, amortizable basis of reforestation expenditures, and exploration expenditures. The distributive shares of these expenses are reported separately to each partner on Schedule K-1.

# **Limitations on Deductions**

## **Section 263A uniform capitalization**

**rules.** The uniform capitalization rules of section 263A generally require partnerships to capitalize certain costs incurred in connection with the following.

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

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

The costs required to be capitalized under section 263A aren't deductible until the property to which the costs relate is sold, used, or otherwise disposed of by the partnership.

***Exceptions.*** For tax years beginning after 2017, a small business taxpayer, defined earlier, can adopt or change its method of accounting to not capitalize costs under section 263A. See section 263A(i) and *Accounting Methods*, earlier. Section 263A doesn't apply to the following.

- Timber.
- Most property produced under a long-term contract.
- Certain property produced in a farming business. See the note at the end of the instructions for line 5, earlier.
- Geological and geophysical costs amortized under section 167(h).



- Certain plants bearing fruits and nuts under section 168(k)(5).

The partnership must report the following costs separately to the partners for purposes of determinations under section 59(e).

- Research and experimental costs under section 174.
- Intangible drilling costs for oil, gas, and geothermal property.
- Mining exploration and development costs.

***Indirect costs.*** Partnerships subject to the uniform capitalization rules are required to capitalize not only direct costs but an allocable part of most indirect costs (including taxes) that benefit the assets produced or acquired for resale, or are incurred because of the performance of production or resale activities.

For inventory, indirect costs that must be capitalized include the following.

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

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

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

special rules. For more details, see Regulations sections 1.263A-8 through 1.263A-15.

For more details on the uniform capitalization rules, see Regulations sections 1.263A-1 through 1.263A-3.

**Transactions between related taxpayers.**

Generally, an accrual basis partnership can deduct business expenses and interest owed to a related party (including any partner) only in the tax year of the partnership that includes the day on which the payment is includible in the income of the related party. See section 267 for details.

**Business interest.** Business interest expense (BIE) is limited for tax years beginning after 2017. See section 163(j) for limitations on deductions for business interest, and section 163(j)(4) for rules specific to partnerships.

**Business startup and organizational costs.** Generally, a partnership can elect to deduct a limited amount of startup or organizational costs paid or incurred. Any costs not deducted must be amortized as explained below. See sections 195(b) and 709(b).

***Time for making an election.*** The partnership generally elects to deduct startup or organizational costs by claiming the deduction on its return filed by the due date (including extensions) for the tax year in which the active trade or business begins. However, for startup or organizational costs paid or incurred before September 9, 2008, the partnership may be required to attach a statement to its return to elect to deduct such costs. See Temporary Regulations sections 1.195-1T and 1.709-1T (as in effect on July 7, 2008) for details. Also, see Regulations sections 1.195-1 and 1.709-1.