

TAX ALERT

I JUST GOT ANOTHER K-1 AND MY RETURN IS DUE TOMORROW!

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Partnerships, S corporations, limited liability companies, estates and trusts are “pass through” tax entities that are required to issue K-1 schedules to their partners, shareholders, members or beneficiaries. A K-1 schedule reports the appropriate share of income, losses, deductions and credits for the year that are passed through to each party who has a beneficial interest in the entity. Each party that has an interest in any of these types of entities is required to include the K-1 schedule on that party’s own income tax return.

The problem with many K-1s is that they are complicated and that they arrive late. This results in additional aggravation and costs to taxpayers and their tax accountants.

Many pass through entities own closely held businesses. There are many deductions and credits that must be calculated and reported by a business on its own tax return on complicated supplemental forms and schedules before it can issue K-1s to its owners. Accountants face tax preparer penalties under the Internal Revenue Code for tax return errors, and therefore they are understandably unwilling to issue K-1’s without a high level of confidence in the completed business tax return.

Many people have in their investment portfolios interests in pass through entities (particularly limited partnerships) that own “alternative investments” such as real estate, oil and gas, timber, commodities and futures. These entities generate deductions and credits that are particularly unique and complicated, and often require significant additional time to complete tax returns containing these items and to issue K-1 to investors.

When investment partnerships are involved, accountants cannot simply take the individual items of income, loss, deduction and credit reported on K-1 schedules and directly transfer them to an owner’s personal income tax return. Owners of interests in investment partnerships fall under the “passive loss rules,” and as a result there are complicated limitations in the amount of losses, deductions or credits that can be claimed in an investor’s personal tax return.

Most tax information reporting forms, like 1099 forms, are required to be sent to taxpayers by January 31st (or in some cases February 15th) following the end of the applicable tax year. This is not the case with the K-1 forms. Taxpayers who receive K-1s are lucky to receive them by the end of March. It is also not usual for a taxpayer to initially receive a K-1, but then later receive one or more subsequent amendments to the original K-1. Many entities file extensions for their own tax returns which results in

all related K-1s being delayed even longer. Late K-1 schedules make it difficult, if not impossible, for a taxpayer to file a timely, accurate personal tax return, and therefore, personal returns must be put on extension.

The current due dates for various types of tax returns are a problem when dealing with K-1s. Partnership returns are due on April 15th. Individual returns are also due on April 15th. The partnership return includes a K-1 schedule that must be delivered to each partner so that they can prepare their personal returns. If the partnership completes its return and delivers the Schedule K-1 to the partners on or shortly before April 15th, the individual partners do not have enough time to incorporate that information into their own personal returns and still file on time. So, the partners have no choice but to file for an extension.

A partnership might file an extension with the IRS for its return. Partnership returns can be extended to September 15th. Although personal returns can be extended to October 15th, corporate and trust returns can only be extended to September 15th. Corporations and trusts as well as individuals may all be owners of interests in partnerships. Therefore the current due dates for both filing “on time” and filing on extension are very challenging when dealing with K-1s.

There is currently pending in Congress “Tax Return Due Date Simplification” legislation designed to help alleviate the due date problems. This legislation is strongly supported by the American Institute of CPAs. The legislation proposes to change the due date of partnership returns from April 15th to March 15th. The due date for S corporation returns would be changed from March 15th to March 30th. The due date for personal and trust returns would continue to be April 15th. The due date for extensions would be changed for S corporations and trusts from September 15th to September 30th. The due date for extensions of partnership returns would remain September 15th, and the due date for personal returns would remain at October 15th. The intention of these changes is to give taxpayers more time after receiving K-1 schedules to file accurate and timely returns. It remains to be seen whether this legislation will be enacted, and if so, how much it would help with the costs and delays relating to K-1s.

The following are some suggestions for dealing with K-1 delays:

1. Get all your other tax information to your accountant as soon as possible even if you have not yet received your K-1s. This will give your accountant the opportunity to get started on the return.
2. Ask your financial advisor about the investments you have that are generating K-1s. The financial benefit of these investments might not be worth the added costs and delays that result from the K-1s.
3. If you are the owner of a closely held company, contact and be proactive with the officers and accountants of the business with regard to the timing of the K-1s. Inquire about what can be done to avoid or reduce delays in getting these forms out to the owners.
4. Support the above mentioned legislation revising tax return due dates.

Please contact our office if you have any questions about K-1 schedules or want to discuss any tax planning issues.