

Form 1065 Issues and Hot Topics

Benjamin Dailey

CPA

TSG Your Trusted Accountant

October 21, 2026

Introduction

- Core form 1065 Problem Areas in Prep
- Asset Basis, Step-Ups, and Depreciation Issues
- Hot Topics and Traps – Transactions with partners

Core 1065 Problem Areas

Form 1065, Part II

Part II Information About the Partner

E Partner's SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)

F Name, address, city, state, and ZIP code for partner entered in E. See instructions.

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

H1 ☐ Domestic partner ☐ Foreign partner

H2 ☐ If the partner is a disregarded entity (DE), enter the partner's:

TIN _____ Name _____

I1 What type of entity is this partner? _____

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

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

	Beginning		Ending	
Profit		%		%
Loss		%		%
Capital		%		%

Check if decrease is due to:

☐ Sale or ☐ Exchange of partnership interest. See instructions.

K1 Partner's share of liabilities:

	Beginning	Ending
Nonrecourse . . . \$		\$
Qualified nonrecourse financing . . . \$		\$
Recourse . . . \$		\$

K2 Check this box if item K1 includes liability amounts from lower-tier partnerships ☐

K3 Check if any of the above liability is subject to guarantees or other payment obligations by the partner. See instructions . . . ☐

L Partner's Capital Account Analysis

Beginning capital account . . . \$	
Capital contributed during the year . . . \$	
Current year net income (loss) . . . \$	
Other increase (decrease) (attach explanation) \$	
Withdrawals and distributions . . . \$(	
Ending capital account . . . \$	

M Did the partner contribute property with a built-in gain (loss)?
☐ Yes ☐ No If "Yes," attach statement. See instructions.

N Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)

Beginning \$	
Ending \$	

Item G-I: Partner Type & Status

- Item G: GP or LLC Member Manager vs. LP or Other LLC Member – self-employment tax position
- Item H1: Partnership-level withholding on allocable share (8804/8805/8813)
- Item H2/I: Disregarded Entity Name / EIN and Entity Type
- Item I2: IRAs may be taxed on UBIT/UDFI

Item J: Changes in Ownership Percentages

- Item J Sale or Exchange check boxes
- 751(a) exchange – partnership has hot assets (unrealized receivables, appreciated inventory, or accelerated depreciation)
- Form 8308 for transfer of partnership interest is due to the transferor and transferee by Jan 31. Part IV has recapture items
- Recapture items are reported on K-1, Line 20AB
- Selling partner must attach a statement to their return w/ similar information to Form 8308

Item K: Partner Liabilities

- Beginning and Ending Share of
 - Nonrecourse liabilities
 - Qualified nonrecourse financing
 - Recourse liabilities
- K2 asks if liabilities includes share from lower-tiered partnerships
- K3 asks if there are any guarantees by partners

Item K1 Workpaper:

			2025			2024	
	WP Ref	Total	Partner 1	Partner 2	Total	Partner 1	Partner 2
<u>Nonrecourse Debt</u>							
Credit Card	5205	20,000	10,000	10,000	15,000	7,500	7,500
<u>Recourse Debt</u>							
Due to Related Party	5215	60,000	30,000	30,000	70,000	35,000	35,000
Bank Loan	5305	20,000	10,000	10,000	25,000	12,500	12,500
NP - Partner 1	5705	13,000	13,000		13,000	13,000	
NP - Partner 2	5710	10,000		10,000	15,000		15,000
		103,000	53,000	50,000	123,000	60,500	62,500

Best Practice: All liabilities on the balance sheet should be reported on Sch K-1 in one of the three categories.
Ask your clients who would have to pay off these debts if the partnership could not

Item K: Partner Liabilities

- Reg. 1.752-2(b)(1) “No value” hypothetical liquidation - Which partner would have to:
 - Pay the creditor?
 - Contribute to the partnership?
 - Reimburse another partner?
- Special rule for liabilities secured by the value of specific assets.
- How much debt would each partner have to pay personally in this scenario?

Item L: Tax Capital

Concept		What it represents	Maintained by	Includes Liabilities?
Sch L, Line 21 Partner Capital		Partnership Capital Per Books	Partnership	Depends on books
Sch M-2 Tax Capital		Total partner tax-basis capital accounts from K-1	Partnership	No
Outside Basis (Tax Basis)		Partners' adjusted basis in the partnership interest	Partner	Yes

Best Practice: Maintain reconciliations detailing the cumulative differences between these three sets of equity records

Item L: Tax Capital Problem Areas

- M-2 / Item L reporting history
 - 2018 required tax capital on Item L if it went negative
 - Notice 2019-66: Tax basis capital accounts required for tax years beginning in 2020
- 734(b) [distribution] adjustments affect tax basis capital, but 743(b) [sale or exchange] adjustments do not
- Return preparers might not have enough information to prepare correct basis schedules

Estimating tax basis [705(b)]

- Formation and ownership history
- How each partner acquired their interest
- All available K-1s and returns
- Accounting records, asset basis, and liabilities
- Use the IRC 705(b)/Reg. 1.705-1(b) alternative method
- Consider disclosing the methodology and key limitations on Form 8275

Item M and N: 704(c) and Built-in Gain

- Item M: Required Statement Showing:
 - Property Contributed, Date of Contribution, and
 - Amount of built-in gain or built-in loss
- Item N: Annual disclosure of beginning and ending unrecognized 704(c)
- Box 20, Code AA – Current year 704(c) allocations
- Box 20, Code W – Distributions of 704(c) property to another partner within 7 years

Form 1065, Part III

1	Ordinary business income (loss)	14	Self-employment earnings (loss)			20	Other information
2	Net rental real estate income (loss)			9c	Unrecaptured section 1250 gain		
3	Other net rental income (loss)	15	Credits	10	Net section 1231 gain (loss)		
4a	Guaranteed payments for services			11	Other income (loss)		
4b	Guaranteed payments for capital	16	Schedule K-3 is attached if checked ☐				
4c	Total guaranteed payments	17	Alternative minimum tax (AMT) items	12	Section 179 deduction	21	Foreign taxes paid or accrued
5	Interest income			13	Other deductions		
6a	Ordinary dividends						
6b	Qualified dividends	18	Tax-exempt income and nondeductible expenses	22	☐ More than one activity for at-risk purposes*		
				23	☐ More than one activity for passive activity purposes*		

Guaranteed Payments

- Guaranteed Payments for Services, but not for the use of capital, are subject to SE tax – report in box 14, Code A
- Common classification issues:
 - Paid for services or partnership profits?
 - GPs do not increase Item L capital account
 - Guaranteed Payments are deducted on Form 1065, Page 1, Ln 10
 - Reg. 1.707-2: Gross-income based payments are in the gray area. Tied to net income, residual economics, or a related income allocation?

Health Insurance – Guaranteed Payment

- Line 4a – Guaranteed Payment for Services (if premiums are treated as a guaranteed payment)
- Line 13, Code M – Other Deductions with an attached statement.
- Line 14 - SE income includes health insurance premiums

Health Insurance - Distribution

- No deduction; no SE tax impact
- Line 20, Code ZZ – Other Information with the amount of health insurance included in distributions
- Check Sch K, K-1 Item L & Part III, and basis schedules
- Consider a supplemental statement for K-1s if unclear

Self-employment – G.P. / LLC Member Manager

- Generally, members include their distributive share in S.E. income unless an exception applies
- Limited partner exception: 1402(a)(13) LPs exclude distributive share from SE income (but not guaranteed payments)
 - Personal liability for debts by reason of member status
 - Authority to contract for the entity
 - Greater than 500 hours participation
 - Partner in fields like health, law, engineering, architecture, accounting, consulting is not a limited partner.

Self-employment – L.P. / LLC Member

- Management authority, services performed, hours, and whether income is generated by services or investment
- CCA 201640014 – IRS treated active LLC member's share of income and GP as SE income, but inactive spouse and trust qualified for the LP exemption
 - Active Participant – Ordinary Income and GP are both SE income
 - Mere Investor – no authority to contract, less than 500 hours

Self-employment – L.P. / LLC Member

- Personal liability by reason of being a partner
- Authority to contract, sign checks, loan docs, ELs, etc
- How much capital did the partner contribute? Is income tied to invested capital?
- Is the partner in a public-facing role?
- How many hours did the client spend in the business?
- What services did the partner provide to the entity?
- Is the partner a manager, officer-equivalent, or decision maker?

Checkbox	Label on 2025 K-1	What it Signals	Partner-Level Use
Box 22	More than one activity for at-risk purposes	Multiple activities for IRC 465 at-risk purposes	Apply at-risk determine if Form 6198 is needed
Box 23	More than one activity for at-risk purposes	Multiple activities for IRC 469 passive activity purposes	Apply PAL/credits and evaluate material participation

- “Activity” is a unit of operations used to apply partner-level limitations
- Liability information needs to be provided by activity too
- Partnership reporting can limit the partners’ options

Schedule K-2 & K-3

- Required when there are items of international tax relevance
- Exception to filing if there is no foreign activity
 - Or only passive-category foreign income shown on a payee statement with under \$300 of foreign taxes
 - Disclose exception on K-1 footnote
- Small taxpayer exception – Sch B, Q4 conditions
- Report sales to foreign jurisdictions even if no income tax was paid

Asset Basis and Depreciation

Special Rules

- Contributed Property and IRC 722/723
- IRC 704(c) allocation methods
- IRC 754 elections and basis adjustments
- Depreciation of IRC 743(b) and 734(b) adjustments

Contributed Assets: IRC 722 and 723

- On contribution of property to a partnership
 - Partner receives outside basis under IRC 722
 - Partnership receives carryover basis under IRC 723
- “Book” capital accounts reflect property at FMV and tax basis at historical cost
- Result is IRC 704(c) built-in gain property – tax depreciation may not follow book

704(c): Built-in Gain/(Loss) and Book-Tax Dep.

- On a sale of 704(c) property pre-contribution gain is specially allocated to the contributing partner
- If the partnership keeps the property, depreciation can reduce (or expose) built-in gain over time
- Depreciation is specially allocated to prevent shifting BIG
 - “Book” depreciation is computed on the property’s FMV
 - Tax depreciation is limited to the property’s carryover basis

Reg. 1.704-3 Allocation Methods

Method	Core Concept	Practical Impact
Traditional Method	Allocate available tax items to reflect BIG/BIL	Ceiling rule: Not enough available tax items
Traditional W/ Curative Allocations	Use other tax items to offset distortions	Requires availability of appropriate curative items
Remedial Method	Creates remedial tax allocations to eliminate distortions	More precise, but more complex tracking

Allocation Example

		A Book Capital Contributing	A Tax Capital Contributing	B Book Capital Noncontributing	B Tax Capital Noncontributing
Beginning Capital		\$100	\$40	\$100	\$100
Traditional Method (Ceiling rule)		-50	-0	-50	-40
Curative Method (reallocation of ordinary income)			+10		-10
Remedial method (not used in this example)					
Ending Capital		\$50	\$50	\$50	\$50

Contributions Subject to Liabilities

- 721 nonrecognition transaction with carryover basis
- Constructive cash flows
 - Contributing partner receives a cash distribution equal to the liability assumed by the partnership
 - Each partner, including contributing partner, makes a deemed cash contribution
- Partner recognizes gain if net debt relief exceeds outside basis, and gain recognition increases outside basis (754 election opportunity)

754 Elections & Asset Basis

Form 1065 (2025)

Page **2**

Schedule B Other Information

- 10a** Is the partnership making, or had it previously made (and not revoked), a section 754 election? If "Yes," enter the effective date of the election
See instructions for details regarding a section 754 election.
- b** For this tax year, did the partnership make an optional basis adjustment under section 743(b)? If "Yes," enter the total aggregate net positive amount \$_____ and the total aggregate net negative amount \$(_____) of such section 743(b) adjustments for all partners made in the tax year. The partnership must also attach a statement showing the computation and allocation of each basis adjustment. See instructions

Form 1065 (2025)

Page **3**

Schedule B Other Information *(continued)*

- c** For this tax year, did the partnership make an optional basis adjustment under section 734(b)? If "Yes," enter the total aggregate net positive amount \$_____ and the total aggregate net negative amount \$(_____) of such section 734(b) adjustments for all partnership property made in the tax year. The partnership must also attach a statement showing the computation and allocation of each basis adjustment. See instructions . . .
- d** For this tax year, is the partnership required to adjust the basis of partnership property under section 743(b) or 734(b) because of a substantial built-in loss (as defined under section 743(d)) or substantial basis reduction (as defined under section 734(d))? If "Yes," enter the total aggregate amount of such section 743(b) adjustments and/or section 734(b) adjustments for all partners and/or partnership property made in the tax year \$_____. The partnership must also attach a statement showing the computation and allocation of the basis adjustment. See instructions . .
- e** Reserved for future use

Yes	No

754 Adjustment Calculation

Election
increases capital
account to
match outside
basis

Transferee
partner gets \$50
of depreciation
deductions

No 754 Election in effect



Outside Basis



Capital Account

754 Election



Outside Basis



Capital Account

754 Election & Basis Step-Ups

- Election applies to transfers of partnership interests and distributions while in effect
- IRS consent is required to revoke
- Some basis adjustments may be mandatory even without an election
- Can produce basis increases that generate additional depreciation deductions or decreases which increase partner tax liability
 - Ask about future transfers, distributions, potential step-downs
 - Consider cost-benefit & administrative complexity

Who owns the benefit from each adjustment?

734(b) adjustments belong to the partnership

- Does not directly change any outside partners basis
- 734(b) adjustment is a partnership level common inside basis adjustment to assets
- If the partnership sells an asset associated with a 734(b) adjustment gain/loss is changed before it is allocated to partners
- Future changes in ownership do not change the asset

Who owns the benefit from each adjustment?

743(b) adjustments belong to the transferee partner

- Outside basis increases from purchase
- 743(b) adjustment: partner-specific inside basis adjustment that reconciles outside to the transferee's share of inside basis
- If the partnership sells an asset associated with a 743(b) adjustment it separately adjusts the gain reported on that partner's K-1
- The adjustment disappears in a taxable sale, it does not carry over to the buyer

743(d) Mandatory Adjustments

- 743(d) requires an adjustment to the basis of partnership property on a transfer of interest upon the death of a partner if the partnership has a substantial built-in loss
- Substantial BIL:
 - Adjusted basis of the total partnership property exceeds FMV by more than \$250,000, or
 - Transferee partner would be allocated more than \$250,000 of loss on a hypothetical sale immediately after the transfer

IRC 755 Allocation rule for basis adjustments

- Step 1: Value each partnership asset (including goodwill) and divide the assets into
 - Ordinary Income (including unrealized receivables & inventory)
 - Capital gain property (1231 and capital assets)
- Step 2: Allocate the increase to ordinary income property first, with the residual allocated to capital gain property
- Step 3: Allocate the adjustment by class & then among individual assets in the class

Hot Topics and Traps

Distributions: What to Watch

Reporting, Partner Level Gain, and Statements:

- Deemed distributions from decreases in partner's share of liabilities
- Marketable securities require statements showing the partnership's basis and FMV for each property
- Noncash distributions – Sch K, Line 19B
- Current vs. Liquidating Distributions
- Built-in gain / mixing bowl rules

Recent distribution reporting changes

Topic	Effective Date	Law or Administrative Guidance
K-1, Box 19, Code D	2025	Deemed money distribution from liability decreases or partnership assumptions of partner debt
K-1, Box 19, Code F, & G	2025	Distributions of cash/marketable securities (F) or other property (G) for performing services
Form 7217	2024	Filed by the partner (not the partnership) for distributions subject to IRC 732
IRC 707(a)(2)	7/4/2025	Technical correction to empower the IRS to apply “Disguised Sale” rules without final regulations
R.R. 2024-14	1/14/25	Applies economic substance principles to related party basis shifting transactions

Sch K: Distributions Codes

Code	Description
A	Cash and marketable securities to non-service partner
B	Distributions subject to IRC 737
C	Other property distributions
D	Deemed distributions of money from decreases in liabilities
F	Cash & marketable securities distributed for performing services
G	Other property distributed for performing services

Code B: 737 Distributions

“Mixing Bowl” rule for property distributions

- Applies to distributions of property when partner previously contributed appreciated property within 7 years
- Partner recognizes gain equal to lesser of
 - FMV of distributed property – partner’s outside basis, or
 - Partner’s net pre-contribution gain
- 704(c) applies to contributed property which was then transferred to another partner

Code D: Decrease in Liabilities

Deemed distribution of money from net decrease in partner's share of liabilities

- Reduces the partner's outside basis and can trigger gain if the deemed distribution exceeds outside basis
- K-1 reports cash distributions & liability decrease deemed distributions separately
- Partnership level amounts are reported on Sch K, Line 19A (includes amounts reported with Codes A, D and F)

Code F&G: Distributions to Service Partners

- Code F: Distributions of cash or marketable securities to a partner for performing services
- Code G: Distribution of property other than cash, securities, or 737 property for performing services
- Guaranteed payments are determined without regard to partnership income:
 - Special allocation of rental income for property mgt. services
 - 10% of net profits for managing operations

Sch B: Asset Distribution Questions

Form 1065 (2025)

Page **3**

Schedule B		Other Information <i>(continued)</i>	Yes	No
11	Check this box if, during the current or prior tax year, the partnership distributed any property received in a like-kind exchange or contributed such property to another entity (other than disregarded entities wholly owned by the partnership throughout the tax year) ☐			
12	At any time during the tax year, did the partnership distribute to any partner a tenancy-in-common or other undivided interest in partnership property?			
27	At any time during the tax year, were there any transfers between the partnership and its partners subject to the disclosure requirements of Regulations section 1.707-8?			

- 11: Like-Kind Exchange
- 12: TIC or undivided interest distribution
- 27: Disguised Sale Disclosure

Form 7217: Disclosing Property Distributions

- Required for 2024 and later years
- Partners file Form 7217 to report tax basis in property distributed to them from a partnership
 - Except cash or certain cash equivalents
- Required even if there is no basis adjustment, and multiple forms could be required if multiple properties are distributed

Form 7217, Part I

Part I Aggregate Basis of Distributed Property on Distribution Date. File a separate form for each date a partner received distributed property.

1	Was this distribution in complete liquidation of the partner's interest in the partnership?	☐ Yes ☐ No
2	Was any part of the distribution treated as a sale or exchange under section 751(b)?	☐ Yes ☐ No
3	Partnership's aggregate basis in distributed property (taking into account any basis adjustments under section 732(d), 734(b), or 743(b)) immediately before the distribution. This line should equal the total of Part II, line B, column (b)	\$ <u>800</u>
4	Adjusted basis of the partner's interest in the partnership immediately before the distribution	\$ <u>1000</u>
5a	Cash received in the distribution	\$ <u>250</u>
b	Fair market value of marketable securities (as defined in section 731(c)) received in the distribution	\$ <u> </u>
c	Add lines 5a and 5b	\$ <u>250</u>
6	Enter the smaller of line 4 or line 5c	\$ <u>250</u>
7	Gain recognized. Subtract line 6 from line 5c. If zero, enter -0- and go to line 9	\$ <u>0</u>
8	Is U.S. tax required to be paid on the gain entered on line 7?	☐ Yes ☐ No
9	Partner's basis in partnership interest reduced by cash received in the distribution. Subtract line 5a from line 4. If zero or less, enter -0-. See instructions if you recognized gain under section 737 as a result of the distribution	\$ <u>750</u>
10	Aggregate basis to be allocated to the distributed property. For a non-liquidating distribution, enter the smaller of line 3 or line 9. For a liquidating distribution, enter the amount from line 9. Line 10 should equal the total of Part II, line B, column (e)	\$ <u>750</u>

Form 7217, Part I

Part II Allocation of Basis of Distributed Property								
(a)	(b)	(c)					(d)	(e)
Description of distributed property (If applicable, include property code. See Pub. 946, Appendix B.)	Partnership's basis in distributed property immediately before the distribution	Check applicable box(es) below. See instructions.					FMV of distributed property	Partner's basis in distributed property after application of section 732
		(i) 732(d)	(ii) 732(f)	(iii) 734(b)	(iv) 743(b)	(v) Reserved for future use		
1	\$	☐	☐	☐	☐	☐	\$	\$
2	\$	☐	☐	☐	☐	☐	\$	\$
3	\$	☐	☐	☐	☐	☐	\$	\$
4	\$	☐	☐	☐	☐	☐	\$	\$
5	\$	☐	☐	☐	☐	☐	\$	\$
6	\$	☐	☐	☐	☐	☐	\$	\$
7	\$	☐	☐	☐	☐	☐	\$	\$
8	\$	☐	☐	☐	☐	☐	\$	\$
9	\$	☐	☐	☐	☐	☐	\$	\$

- Disclose each property (if multiple) and apply ordering rules for basis allocation
- Partnership 754 election may require basis adjustments

Question 27 – Reg. 1.707-8 Disclosure

- Partner transfers property to partnership & the partnership transfers payment to the partner within two years (regardless of order), and the transaction is not reported as a sale
- Partnership transfers property to a partner and the partner transfers payment to the partnership within two years (regardless of order)
- Either party treats certain liabilities incurred within two years as qualified liabilities and they are included in a “disguised sale” transaction

Reg. 1.707-8 Disclosure Statement

- Caption identifying the statement as a disclosure under IRC 707
- Identification of the item, group of items, or transactions being disclosed
- The amount of each item being disclosed
- The facts affecting the potential tax treatment of the items or transactions

Partnership Disguised Sale (7/4/25)

- Disguised Sale ex. Partner contributes land to a partnership and receives a large cash distribution in the following year
- Taxpayers were arguing that a technical error in the statute precluded enforcement
- Eliminated the argument that the IRS cannot recharacterize a contribution/distribution based on the absence of regulations

Reporting Basis-Shifting Transactions

- Rev. Rul. 2024-14 is an anti-abuse rule that applies economic substance arguments to related party partnership transactions that trigger basis adjustments under 732(b), 734(b), or 743(b)
- Basis must increase more than \$10M/year or \$25M for transactions within the 6 year look back
- Notice 2025-23 changed the reporting retroactively & waived penalties, but not the underlying rules

FINAL SLIDE

