

INSTRUCTIONS FOR THE PREPARATION OF
ALABAMA DEPARTMENT OF REVENUE
Pass Through Entity

2010

Owner's/Shareholder's Statement of Income and Deductions

**Issues Concerning the Preparation of
the Alabama Schedule K-1
(Form 65 and Form 20S)**

Qualified Investment Partnerships. The Alabama Legislature passed the Entertainment Industry Incentive Act of 2009 during the regular 2009 legislative session. The law, Act Number 2009-144, created an entity referred to as a Qualified Investment Partnership (QIP).

The law creates §40-18-24.2, *Code of Alabama 1975*, which generally defines a QIP as a partnership or other entity classified as a subchapter K entity, or a business trust as defined in §40-18-1, *Code of Alabama 1975*, that for a tax period meets the gross income and asset requirements for a Qualified Investment Partnership as required by §40-18-24.2; and, for which an authorized officer, partner, member or manager of the entity has certified for the tax period that the entity meets the gross income and asset requirements. Proper certification of a QIP requires the completion of Alabama Schedule QIP-C, Qualified Investment Partnership Certification, which must be filed by the due date of the Alabama partnership income tax return for the entity.

The requirements concerning the Alabama QIP are similar to the qualified investment partnership provisions in other states, but are not necessarily the same. Instructions for the preparation of Alabama Schedule QIP are available on the Department's website, along with additional information concerning the Alabama QIP.

Alabama Form 65 and Schedule K-1 for Alabama Form 65 have been revised to accommodate the QIP income tax return requirements. An Alabama partnership return filed by a QIP must be indicated by completing the QIP indicator on page one of the Form 65 and on each K-1 accompanying the return. Nonresident members of the QIP that receive exempt income from the QIP would receive an Alabama Schedule K-1 with the QIP indicator properly marked and with the total amount of Alabama exempt income reported on Line AB, Alabama Exempt Income. Regulations to implement the law are on the Department's Web site.

Qualifying Employers Deduction for Employee Health Insurance (Small Business Health Insurance Premium Deduction). The Alabama Legislature passed Act Number 2008-559 during the 2008 legislative session. The law allows qualifying employers to deduct fifty percent (50%) of the amount paid as health insurance premiums on qualifying employees in connection with an employer-provided health insurance plan.

Qualifying employers are defined in the law as employers with less than 25 employees. Qualifying employees are defined in the law as those employees that are Alabama residents, earn no more than \$50,000 of wages, and report no more than \$75,000 of Alabama Adjusted Gross Income (\$150,000 if married filing jointly).

The amount of the deduction should be entered on Line 10 of the Schedule K for the Alabama partnership income tax return or the Alabama S-Corporation return. Each owner/shareholder should receive an Alabama Schedule K-1 reporting on Line Y (Small Business Health Insurance Premiums) the amount of the deduction.

For additional information concerning the deduction, see §40-18-

15.3, *Code of Alabama 1975*. Alabama Department of Revenue Regulation Number 810-3-15.3-.01, Deductions for Small Business Health Insurance Premiums, is available on the Department's Web site.

Composite Payment and Return Requirements for Partnerships. The Entertainment Industry Incentive Act of 2009, Alabama Act Number 2009-144, also revised composite payment and return requirements for partnerships.

Under the law, a partnership, or other entity classified as a Subchapter K entity, is required to file a composite return and make composite payments on behalf of its nonresident owners or members if there are one or more nonresident owners or members at any time during the taxable year. The law specifically exempts estates, trusts, and business trusts from the requirement to file a composite return and make a composite payment. The law generally exempts Alabama QIPs from the composite payment and return requirement. The instructions for Alabama Form PTE-C, Nonresident Composite Payment Return are available on the Department's Web site, along with additional information concerning the composite payment and return requirements for partnerships. Regulations to implement the law are on the Department's Web site.

Decoupling from the Federal Depreciation and Section 179 Expense Deduction Rules. The Alabama Legislature decoupled Alabama Income Tax Law from the bonus depreciation and additional Section 179 expense deductions for the federal Economic Stimulus Act of 2008. As a result, the both the Form 65 and the Form 20S provide a means to record Alabama-allowed depreciation. Also, as a result of the decoupling, assets disposed of might have an Alabama basis different from the federal basis, resulting in a gain or loss for Alabama income tax purposes that might differ from the gain or loss for federal income tax purposes. Both the Form 65 and the Form 20S provide a means to make the required adjustment. As of the time this document was finalized, the Alabama Legislature has passed no other legislation decoupling Alabama Income Tax Law from the federal depreciation and Section 179 expense deduction rules.

Instructions to Pass-Through Entity

General Instructions. The Alabama Schedule K-1 is a required attachment to the Alabama Form 65 and the Alabama Form 20S. The Alabama Schedule K-1 is similar to the federal Schedule K-1 in that it is used to report the pass-through entity owners' share of income, deductions, credits and other items.

The format of the Alabama Schedule K-1 differs from that of the federal Schedule K-1 – therefore the federal Schedule K-1 cannot serve as a substitute for the Alabama Schedule K-1.

The term "pass-through entity" will be used in these instructions to refer to Alabama S corporations and subchapter K entities. Generally, the term "pass-through entity owner" will be used in these instructions to refer to any shareholder of an Alabama S corporation doing business in Alabama or any owner of a subchapter K entity doing business in Alabama. See Section 40-18-160, *Code of Alabama 1975*, for an explanation of an Alabama S corporation. See

Section 40-18-1, *Code of Alabama 1975*, for a definition of subchapter K entity.

Heading Information. Enter in the upper left area of the form whether the pass-through entity is a Subchapter K entity or an Alabama S corporation. Provide the tax period information if the return is filed for other than the 2010 calendar year. Enter in the upper right area of the form if the Schedule K-1 is either a final K-1 or an amended K-1. Also indicate if the entity qualifies as a Qualified Investment Partnership (QIP).

Part I – Information About the Pass-Through Entity.

Enter on line A the pass-through entity's Federal Employer Identification Number. Enter on line B the pass-through entity's name and mailing address (street address, city, state and zip code).

Part II – Information About the Pass-Through Entity Owner.

Line C. Enter the pass-through entity owner's social security number or federal identification number.

Line D. Enter the name of the pass-through entity owner.

Line E. Enter the street address of the pass-through entity owner.

Line F. Enter the city, state, and zip code for the pass-through entity owner.

Line G. If the pass-through entity is an Alabama S corporation, line G does not apply. Otherwise, check the appropriate box to indicate if the pass-through entity owner is a general partner or limited liability company member manager or if the pass-through entity owner is a limited partner or a non-manager member of a limited liability company.

Line H. Enter the entity type of the pass-through entity owner (individual, trust, partnership, S corporation, C corporation or disregarded entity).

Line I. Enter the pass-through entity owner's percentage of profit and (loss) sharing during the tax year.

Line J. Check the appropriate box to indicate if the pass-through entity owner is a nonresident.

The second part of Line J applies only to S corporations. Check the box if an Alabama Schedule NRA has been filed for a nonresident shareholder.

Line K. Line K applies only to owners of Subchapter K entities. Enter the amount of the owner's capital account at the end of the year, as shown on the federal Schedule K-1 for the owner. Then indicate the basis for arriving at the owner's capital balance, as shown on the federal Schedule K-1.

Line L. Enter additional notes, as needed.

Part III – Owner's/Shareholder's Share of Current Year Alabama Income, Deductions, Credits, and Other Items.

Line M. Enter the pass-through entity owner's prorata share of the nonseparately stated income allocated and apportioned to Alabama. The total amount apportioned to Alabama for the pass-through entity is reported on Schedule K, line 1 (Alabama Amount column) of the accompanying Alabama Form 65 or Alabama Form 20S.

Line N. Line N applies only to owners of subchapter K entities.

The entire amount of guaranteed payments received by the owner of the subchapter K entity should be reported on this line - if the owner is an Alabama resident individual, a subchapter K entity,

or a corporation. The apportioned amount of the guaranteed payments received by the owner of the subchapter K entity should be reported on this line, only if the owner is an individual that is not an Alabama resident.

Line O. Enter the pass-through entity owner's prorata share of the section 179 expense apportioned to Alabama. The total amount apportioned to Alabama for the pass-through entity is reported on Schedule K, line 4c (Alabama Amount column) of the accompanying Alabama Form 65 or Alabama Form 20S.

Act Number 2008-549, passed by the Alabama Legislature during the first 2008 Special Session, decoupled Alabama income tax laws from the bonus depreciation and additional Section 179 provisions of the federal Economic Stimulus Act of 2008.

Line P. Enter the pass-through entity owner's prorata share of the interest expense related to portfolio income apportioned to Alabama. The total amount apportioned to Alabama for the pass-through entity is reported on Schedule K, line 7 (Alabama Amount column) of the accompanying Alabama Form 65 or Alabama Form 20S.

Line Q. Enter the pass-through entity owner's prorata share of the portfolio income apportioned to Alabama. The total amount apportioned to Alabama for the pass-through entity is reported on Schedule K, line 6 (Alabama Amount column) of the accompanying Alabama Form 65 or Alabama Form 20S. The different types and amounts of portfolio income items must be provided to the pass-through entity owner with the Alabama Schedule K-1.

Line R. Enter the pass-through entity owner's prorata share of the other expenses related to portfolio income apportioned to Alabama. The total amount apportioned to Alabama for the pass-through entity is reported on Schedule K, line 8 (Alabama Amount column) of the accompanying Alabama Form 65 or Alabama Form 20S. Interest expense must not be included in this amount. The pass-through entity owner must be provided with the nature and amounts of the different expenses reported on Line R with the Alabama Schedule K-1.

Line S. Enter the pass-through entity owner's prorata share of the charitable contributions apportioned to Alabama. The total amount apportioned to Alabama for the pass-through entity is reported on Schedule K, line 2 (Alabama Amount column) of the accompanying Alabama Form 65 or Alabama Form 20S.

Line T. Enter the pass-through entity owner's prorata share of the other separately stated business items apportioned to Alabama. The total amount apportioned to Alabama for the pass-through entity unit is reported on Schedule K, line 9 (Alabama Amount column) of the accompanying Alabama Form 65 or Alabama Form 20S. The nature and amount of each different separately stated business item must be provided to the pass-through entity owner with the Alabama Schedule K-1.

Line U. Enter the amount of the Alabama composite payment made on behalf of the pass-through entity owner. The total amount of composite payments made by the pass-through entity is reported on Schedule K, line 12 (Alabama Amount column) of the accompanying Alabama Form 65 or Alabama Form 20S.

Line V. Enter the pass-through entity owner's prorata share of the U.S. income taxes paid by the pass-through entity and apportioned to Alabama, if any. The total amount apportioned to Alabama for the pass-through entity is reported on Schedule K, line 13 (Alabama Amount column) of the accompanying Alabama Form 65 or Alabama Form 20S.

Line W. Enter the pass-through entity owner's prorata share of

the casualty losses apportioned to Alabama. The total amount apportioned to Alabama for the pass-through entity is reported on Schedule K, line 5 (Alabama Amount column) of the accompanying Alabama Form 65 or Alabama Form 20S.

Line X. Enter the amount of distributions made to the pass-through entity owner. The total amount for the pass-through entity is reported on Schedule K, line 15 (Alabama Amount column) of the accompanying Alabama Form 65 or Alabama Form 20S. Provide with the Alabama Schedule K-1 a detailed explanation of the amount reported on Line X.

Line Y. Enter the pass-through entity owner's prorata share of the small business health insurance premiums. The total amount for the pass-through entity is reported on Schedule K, line 10 of the accompanying Alabama Form 65 or Alabama Form 20S.

Line Z. Enter the pass-through entity owner's prorata share of the oil and gas depletion apportioned to Alabama. The total amount apportioned to Alabama for the pass-through entity is reported on Schedule K, line 3 (Alabama Amount column) of the accompanying Alabama Form 65 or Alabama Form 20S. The computation of the amount reported on Line Z of the Alabama Schedule K-1 must be provided to the pass-through entity owner with the Alabama Schedule K-1.

Line AA. Enter the pass-through entity owner's prorata share of separately stated nonbusiness items allocated to Alabama. The total amount allocated to Alabama for the pass-through entity is reported on Schedule K, line 11 (Alabama Amount column) of the accompanying Alabama Form 65 or Alabama Form 20S. The pass-through entity owner must be provided with the nature and amounts of the different separately stated nonbusiness items reported on Line AA.

Line AB. Enter the pass-through entity owner's prorata share of income exempt from Alabama income taxation. The total amount of Alabama exempt income for the pass-through entity is reported on Schedule K, line 14 (Alabama Amount column) of the accompanying Alabama Form 65 or the Alabama Form 20S. The pass-through entity owner must be provided with the nature and amounts of the different Alabama exempt income reported on Line AB.

Instructions to Pass-Through Entity Owner

Important Information for pass-through entity owners that are not individuals. Pass-through entity owners that are not individuals, but are corporations or subchapter K entities can create nexus (a presence subjecting the pass-through entity owner to Alabama income taxation) in Alabama by having an ownership interest in a pass-through entity doing business in Alabama. Also, having an ownership interest in a pass-through entity doing business in Alabama can subject the pass-through entity owner (which is a corporation or subchapter K entity) to the requirements of the Alabama Multistate Tax Compact. The Alabama Department of Revenue's Web site (www.revenue.alabama.gov) has additional information available concerning Alabama income tax laws and regulations; the Alabama Multistate Tax Compact; Alabama tax forms and instructions; as well as, frequently asked questions should you need to conduct more in-depth research.

The remainder of these instructions are directed toward pass-through entity owners that are individual taxpayers.

Line M. Pass-through entity owners that are individuals would

report this amount less any amount shown on Line Y on Schedule E of the Alabama Form 40 or Alabama Form 40NR.

Line N. Line N applies only to owners of subchapter K entities.

Pass-through entity owners that are individuals would report this amount on Schedule E of the Alabama Form 40 or Alabama Form 40NR.

The entire amount of guaranteed payments received by the owner of the subchapter K entity should be reported on this line of the Schedule K-1, if the owner is an Alabama resident individual. The apportioned amount of the guaranteed payments received by the owner of the subchapter K entity should be reported on this line, if the owner is an individual, but not an Alabama resident.

Line O. Pass-through entity owners that are individuals would claim this amount on the Form 4562, Depreciation and Amortization, which accompanies the individual's Alabama Form 40 or Alabama Form 40NR.

Line P. Pass-through entity owners that are individuals would report this amount on the Alabama Form 4852A that accompanies the individuals Alabama Form 40 or Alabama Form 40NR.

Line Q. Pass-through entity owners that are individuals would report this amount on the appropriate schedule of the Alabama Form 40 or Alabama Form 40NR filed by the individual, depending upon the nature of the portfolio income. Accompanying the Alabama Schedule K-1 should be an explanation of the different types and amounts of portfolio income making up the amount on Line Q.

Line R. Pass-through entity owners that are individuals would claim this amount on Schedule A of the Alabama Form 40 or Alabama Form 40NR, depending upon the nature of the expense. Accompanying the Alabama Schedule K-1 should be an explanation of the different types and amounts of expenses making up the amount on Line R.

Line S. Pass-through entity owners that are individuals would claim this amount on Schedule A of the Alabama Form 40 or Alabama Form 40NR.

Line T. Pass-through entity owners that are individuals would report or claim these items on the appropriate schedule of the Alabama Form 40 or Alabama Form 40NR, filed by the individual, depending upon the nature of the other separately stated business item. Accompanying the Alabama Schedule K-1 should be an explanation of the different types and amounts of other separately stated business items making up the amount on Line T.

Line U. Pass-through entity owners that are individuals would claim this amount on the Alabama Form 40 or Alabama Form 40NR.

Line V. Pass-through entity owners that are individuals would report this amount on the Alabama Form 40 or Alabama Form 40NR.

Line W. Pass-through entity owners that are individuals would claim this amount on the Form 4684 that accompanies the Alabama Form 40 or Alabama Form 40NR.

Line X. Pass-through entity owners that are individuals would report the portion of this amount that represents reportable income on the Schedule D accompanying the Alabama Form 40 or Alabama Form 40NR. Accompanying the Alabama Schedule K-1 should be a detailed explanation of the amount on Line X.

Line Y. Pass through owners should subtract the amount shown on line Y from the amount shown on line M. This figure represents the additional health insurance deduction allowed for small business employers with Alabama employees. For more information on this deduction, see §40-18-15.3.

Line Z. Pass-through entity owners that are individuals should claim this amount on Schedule E of the Alabama Form 40 or Ala-

bama Form 40NR. Accompanying the Alabama Schedule K-1 should be a computation of the amount reported on Line Z. Alabama income tax law concerning oil and gas depletion differs from the federal law - care should be exercised in claiming this deduction, to ensure that the proper amount is deducted.

Line AA. Pass-through entity owners that are individuals would report or claim this amount on the Alabama Form 40 or Alabama Form 40NR, depending upon the nature of the separately stated nonbusiness items. Accompanying the Alabama Schedule K-1 should be an explanation showing the different types of nonbusiness items and amounts making up the amount reported on Line AA.

Line AB. Pass-through entity owners that are individuals are encouraged to disclose the amount of Alabama exempt income on the Alabama Form 40 or Alabama Form 40NR, filed by the individual. Accompanying the Alabama Schedule K-1 should be an explanation showing the different types of Alabama exempt income items and amounts making up the amount reported on Line AB.

Domestic Production Activities Deduction

Internal Revenue Code Section 199

Added by the American Jobs Creation Act of 2004 (P.L. 108-357), Internal Revenue Code Section 199 allows taxpayers the Domestic Production Activities Deduction – which is a deduction for income attributable to domestic production activities. The deduction is effective for tax years beginning in 2005 and thereafter. According to

federal income tax law, a taxpayer engaged in a qualified production activity (QPA) may claim a deduction against gross income equal to the applicable percentage of its qualified production activities income, with certain limitations.

Alabama Income Tax Treatment (Issued: January 1, 2006)

Individuals: Individual taxpayers subject to the Alabama individual income tax law are not allowed to claim the Domestic Production Activities Deduction in computing the taxpayer's Alabama taxable income. The deduction is not allowed to individual taxpayers even if the individual taxpayer is an owner or shareholder of a pass-through entity which has gross receipts derived from qualifying production activities (QPA). Unlike Alabama's corporate income tax, Alabama's individual income tax is not directly tied to federal taxable income. A statutory change to Alabama's individual income tax law would be required to conform to the federal deduction.

Pass-through Entities: Alabama pass-through entities (S-corporations, subchapter K entities, and trusts) do not take the Domestic Production Activities Deduction, but rather report (as a separately stated item) the information required for computing the Domestic Production Activities Deduction to pass-through entity owners and shareholders.

Corporations: Corporations subject to Alabama corporate income tax law are allowed the deduction. The computation of corporate taxable income according to Alabama income tax law is tied to federal taxable income (see Section 40-18-33, Code of Alabama 1975).