Chapter 9 – Recommended Problems & Solutions

1. [LO 1] What is a *flow-through entity*, and what effect does this designation have on how business entities and their owners are taxed?

   Flow-through entities are entities that are not taxed on the entity level; rather, these entities are taxed on the owner's level. These types of entities conduct a regular business; however, the income earned and deductions allowed are passed to the owners of these flow-through entities. The owners are then taxed on the amount allocated to them. Thus, flow-through entities provide a way for income and deductions to be taxed only once instead of twice.

2. [LO 1] What types of business entities are taxed as flow-through entities?

   The two main business entities that are taxed as flow-through entities are partnerships and S corporations. Partnerships are taxed under Subchapter K and consist of general partnerships, limited partnerships, and limited liability companies (LLC). S corporations are taxed under Subchapter S. Both these types of business entities are treated as flow-through entities and are taxed accordingly.

4. [LO 2] What is a partnership interest, and what specific economic rights or entitlements are included with it?

   A partnership interest is an equity interest in a partnership. This interest is created through a transfer or sale of cash, property, or services in exchange for an equity interest in the partnership. A partnership interest gives each partner certain rights or entitlements. The two main economic rights are a capital interest and profit interest in the partnership. A capital interest is the right for a partner to receive a share of the partnership assets during liquidation. A profit interest is the right or obligation for a partner to receive a share of the future income or losses of the partnership.

5. [LO 2] What is the rationale for requiring partners to defer most gains and all losses when they contribute property to a partnership?

   The rationale for requiring partners to defer most gains and losses when contributing property to a partnership is twofold. First, the IRS desires that entrepreneurs have a way to start their own business without having to pay any taxes upfront. Second, the partners are considered as still owning the property they have contributed to the partnership. While they don't own the property outright, each partner has a small percentage of the property contributed in her/his partnership interest she/he exchanged for. This second reasoning helps further support the idea that partnerships follow the aggregate concept.

7. [LO 2] What is *inside basis* and *outside basis*, and why are they relevant for taxing partnerships and partners?
   An inside basis, in relation to partnerships, is the basis the partnership takes in the assets that the partnership holds. An outside basis, in relation to partnerships, is the tax basis each partner has in the partnership. The inside basis is necessary to compute the gain/loss recognized on all property sold by the partnership. The outside basis is necessary to compute the gain/loss recognized on the partnership interest when sold. For tax purposes, the inside basis is similar to the basis the partner had in the property prior to contribution. On the other hand, the outside basis corresponds not only to the contributed property, but also to the debt and income/losses of the partnership that have been allocated to the individual partners.

8. [LO 2] What is recourse and nonrecourse debt, and how is each generally allocated to partners?

   Recourse debt is debt for which partners are considered to have an economic risk of loss. Partners are legally liable for recourse debt and must satisfy this type of debt personally if the partnership cannot. An example of recourse debt is accounts payable owed by a general partnership. Nonrecourse debt is debt for which no partners are considered to have an economic risk of loss because nonrecourse debt is typically secured by real property. An example of nonrecourse debt is a mortgage on a building.

   In regards to a partnership's debt, recourse debt is allocated to those partners that have the ultimate responsibility of paying the debt. The debt is allocated to the partners that have an economic risk of loss. On the other hand, nonrecourse debt is generally allocated to the partners according to their profit sharing ratios. Despite the partners not being legally liable for some debt, all debt is allocated to adjust the outside basis of the partners.

9. [LO 2] How does the amount of debt allocated to a partner affect the amount of gain a partner recognizes when contributing property secured by debt?

   A partner that contributes property secured by debt is not only contributing the property to the partnership but also the debt. The partner's tax basis in his or her partnership interest would be increased by the basis of the assets contributed. Next, the property's debt is allocated to each partner according to who is ultimately responsible for it or by each partner's profit-sharing ratio. The basis of the contributed assets plus the allocation of debt would represent the partner's tax basis in the partnership immediately before the deemed distribution of cash as a result of the relief of debt attached to the contributed property. If the partner is not allocated enough debt, the partner's outside basis will become negative and a gain must be recognized. Thus, a partner can only avoid gain by being allocated enough of the partnership debt to keep her/his basis at least above zero.

10. [LO 2] What is a tax basis capital account, and what type of tax-related information does it provide?

A tax basis capital account is an equity account that is created for each partner of the partnership. This account is measured using the tax accounting rules. The account reflects tax basis of any capital contributions (i.e., property and cash), capital distributions, and future earnings and losses allocated to that partner. Additionally, a tax basis capital account can provide more tax-related information for each partner. For instance, each partner's share of inside basis of the partnership's assets can be calculated by adding the partner's share of debt to her/his capital account.

11. [LO 2] Distinguish between a capital interest and a profits interest, and explain how partners and partnerships treat when exchanging them for services provided.

A partnership interest can be broken down into two distinct rights: (1) capital interest and (2) profits interest. To become a partner in a partnership, you will receive at least one of these rights. A capital interest is the right to receive a share of the partnership assets at liquidation. A profits interest is the right to share in the future earnings and losses of the partnership. While these rights are given to most partners that contribute cash or property, special rules exist when these rights are given to partners in exchange for services.

When a partner receives a capital interest in exchange for services rendered to the partnership, the partner must treat the liquidation value of the capital interest as ordinary income. Further, the tax basis for the partner will be equivalent to the amount of ordinary income recognized. The holding period for this tax basis will begin on the date the capital interest is received. From the partnership's perspective, the partnership can deduct or capitalize the value of the capital interest depending upon the type of services rendered. This is determined on a fact and circumstance basis. Additionally, the amount deducted by the partnership is allocated to the non-service partners as consideration for effectively transferring a portion of their capital interest to the service partner.

When a partner receives a profits interest in exchange for services rendered to the partnership, the partner has no immediate tax impact because the profits interest has no liquidation value at the time the interest is received. Thus, the non-service partners will not receive any deductions for adding the additional partner to the partnership. As the partnership makes future profits and losses, the service partner will be allocated her/his portion of these losses according to the profit sharing ratios. The debt allocated to non-service partners must also be redistributed with the additional service partner receiving her/his portion of debt. Therefore, the initial tax basis of a service partner with only a profits interest will either be zero or the portion of debt the partner is allocated (if any).

12. [LO 2] How do partners who purchase a partnership interest determine the tax basis and holding period of their partnership interests?

When a partner purchases a partnership interest, the initial tax basis for the partner is determined by taking the cost basis of the interest the partner purchased and adding to this basis any debt allocated to the partner's interest. The holding period for this purchased interest will begin on the date that the partner purchased the partnership interest.

17. [LO 3] When are partnerships eligible to use the cash method of accounting?

Under the tax accounting rules, a partnership with a corporate partner must use the accrual method of accounting unless the following exception applies. A partnership with a corporate partner is eligible to use the cash method of accounting when the partnership has average gross receipts over the past three taxable years less than or equal to $25 million.

18. [LO 4] What is a partnership's ordinary business income (loss) and how is it calculated?

Through the course of business, partnerships create income or losses. Some of these items are considered to affect a specific partner or groups of partners differently. Thus, these separately-stated items must be reported on a partner-by-partner basis. Then, after adjusting the partnership's business income (loss) for these separately-stated items, the partnership reports the remaining amount of business income (loss) to ordinary business income (loss). The total amount will be allocated to each partner according to the special allocation rules agreed upon or else based upon the profit sharing ratios of the partnership.

19. [LO 4] What are some common separately stated items, and why must they be separately stated to the partners?

Separately-stated items must be taken out of ordinary income (loss) because these items either (1) relate only to a specific partner in the partnership or (2) the item is taxed differently for each partner depending upon the entity of the partner and the partner's current tax situation. The following is a partial list of items that are separately stated on a partnership return.

1. *Short-term capital gains (losses)*
2. *Long-term capital gains (losses)*
3. *Section 1231 gains (losses)*
4. *Charitable contributions*
5. *Dividends*
6. *Interest income*
7. *Guaranteed payments*

8. *Net earnings (losses) from self-employment*
9. *Tax-exempt income*
10. *Net rental real estate income (loss)*
11. *Investment interest expense*
12. *Section 179 deductions*

20. [LO 4] Is the character of partnership income/gains and expenses/losses determined at the partnership or partner level? Why?

    In keeping with the entity concept, the character of all income/gains and expenses/losses is determined at the partnership level. Despite the chance that specific items would change character depending upon the partner who holds them, Congress has decided to unify the character of all items by looking at the character from the partnership's perspective. Thus, partnerships are required to file a form 1065 return along with all partners' K-1s to help properly report the amounts and character of various items that show up on the individual partner's return.

21. [LO 4] What are guaranteed payments and how do partnerships and partners treat them for income and self-employment tax purposes?

    Guaranteed payments are similar to cash salary payments for services provided. Fixed payments made to a partner in the capacity as a partner no matter the profit (loss) of the partnership for that tax year are known as guaranteed payments. Thus, on the partnership level, they are treated like a salary payment to an unrelated party. The partnership deducts the guaranteed payment in computing the partnership's ordinary business income (loss).

    On the partner level, the partner that receives a guaranteed payment must account for the guaranteed payment as a separately-stated item that is taxed as ordinary income. Further, the partner must include the amount of the guaranteed payment in computing self-employment income for tax purposes. This reporting requirement is required no matter if the partner is a general partner, limited partner, or LLC member.

22. [LO 4] How do general and limited partners treat their share of ordinary business income for self-employment tax purposes?

    In determining how different partners treat their share of ordinary business income, the IRS assesses the involvement the partner has in the partnership. General partners are considered to be actively involved in the management of the partnership. Thus, the general partner's share of ordinary business income is treated as trade or business income and is subject to self-employment tax. Conversely, limited partners are generally not actively involved with managing the partnership. The limited partner's share of ordinary business income is treated as investment income and not subject to self-

employment tax. Both types of partners must treat guaranteed payments as income relating to self-employment; however, the treatment of ordinary business income for purposes of self-employment tax depends on the type of partner.

25. [LO4] What are the basic tax-filing requirements imposed on partnerships?

While a partnership does not pay taxes, the IRS still requires all partnerships to file an information return to the IRS – Form 1065 (U.S. Return of Partnership Income). This form must be filed by the 15th day of the 3rd month of the partnership's year end. For calendar year end partnerships, the form must be filed by March 15th. An extension is available to file by the due date of the original return and provides the partnership an additional six months to file Form 1065. The extension must be filed on Form 7004.

The tax return that must be filed by all partnerships consists of a detailed calculation of the partnerships ordinary business income (loss) on page 1 of Form 1065. On page 3 of Form 1065, Schedule K must be filled out which lists the ordinary business income (loss) along with any separately-stated items. This schedule is an aggregate of each partner's share of items both separately-stated and non-separately stated. In addition, each partner's proportion of the above items is reported on a Schedule K-1. A Schedule K-1 for every partner must be filed with Form 1065, and each individual partner will receive her/his own Schedule K-1 from the partnership.

27. [LO 5] Why does a partner's tax basis in her partnership need to be adjusted annually?

A partner's tax basis needs to be adjusted annually for the following three reasons. First, a partner does not want to double count any income/gain from the partnership when she/he sells her/his partnership interest or receive a distribution from the partnership. Second, the IRS does not want partners to double count any expenses/losses from the partnership in a similar situation from above. Last, partners want to make sure they adjust for tax-exempt income and non-deductible expenses, so these items will not ultimately be taxed or deducted at the time of selling a partnership interest or receiving a distribution from the partnership.

28. [LO 5] What items will increase a partner's basis in her partnership interest?

The following items will increase a partner's basis and must be adjusted for on an annual basis in the order given.

1. *Actual and deemed cash contributions to the partnership*
2. *Partner's share of ordinary business income*
3. *Partner's share of separately-stated income/gain items and*
4. *Partner's share of tax-exempt income*

29. [LO 5] What items will decrease a partner's basis in her partnership interest?

The following items will decrease a partner's basis and must be adjusted for on an annual basis in the order given. These items will be adjusted after all the increases to a partner's basis have been taken into effect.

1. *Actual and deemed cash distributions from the partnership*
2. *Partner's share of non-deductible expenses (fines, penalties, etc.)*
3. *Partner's share of ordinary business losses and*
4. *Partner's share of separately-stated expenses/loss items*

31. [LO 6] What happens to partnership losses allocated to partners in excess of the tax basis in their partnership interests?

Losses that are allocated to partners that exceed the partner's tax basis cannot be used during the current taxable year. The excess loss will be suspended and carried forward indefinitely until the partner has sufficient basis to utilize the losses. A partner would be able to increase her/his tax basis by (1) making a capital contribution, (2) guaranteeing more partnership debt, or (3) helping the partnership become more profitable. Once the partner's tax basis is positive, the losses previously suspended can be used.

37. [LO 2] Joseph contributed $22,000 in cash and equipment with a tax basis of $5,000 and a fair market value of $11,000 to Berry Hill Partnership in exchange for a partnership interest.
    a. What is Joseph's tax basis in his partnership interest?
    b. What is Berry Hill's basis in the equipment?

a. $27,000.
Joseph's tax basis is considered to be his outside basis in the partnership. The tax basis includes the $22,000 in cash and his original basis in the equipment, $5,000. Joseph's holding period for his outside basis would depend upon the holding period of the assets contributed. If property contributed is a capital or Section 1231 asset, the holding period for that portion of the partnership interest includes the holding period of the contributed property. Otherwise, the holding period of the partnership interest begins on the date it is received.

b. $5,000.
Berry Hill Partnership's basis in the equipment is a carryover basis from the partner who contributed the equipment. The basis in the equipment plus the basis in the cash will give us Berry Hill Partnership's inside basis. The holding period for the equipment carries over to the Berry Hill Partnership from Joseph.

38. [LO 2] Lance contributed investment property worth $500,000, purchased three years ago for $200,000 cash, to Cloud Peak LLC in exchange for an 85 percent profits and capital interest in the LLC. Cloud Peak owes $300,000 to its suppliers but has no other debts.

   a. What is Lance's tax basis in his LLC interest?
   b. What is Lance's holding period in his interest?
   c. What is Cloud Peak's basis in the contributed property?
   d. What is Cloud Peak's holding period in the contributed property?

a. $455,000.
Lance's basis in his LLC interest is made up of the $200,000 basis of the investment property he transferred to the LLC and his $255,000 share of the LLC debt (85% x $300,000). Because LLC general debt obligations are treated as nonrecourse debt, Lance's profit sharing ratio is used to allocate a portion of the LLC debt to him.

b. Three years.
Because Lance contributed a capital asset, the holding period of the contributed assets "tacks onto" his partnership interest.

c. $200,000.
The LLC takes a carryover basis in the contributed property.

d. Three years.
The LLC inherits Lance's holding period in the contributed property.

39. [LO 2] Laurel contributed equipment worth $200,000, purchased 10 months ago for $250,000 cash and used in her sole proprietorship, to Sand Creek LLC in exchange for a 15 percent profits and capital interest in the LLC. Laurel agreed to guarantee all $15,000 of Sand Creek's accounts payable, but she did not guarantee any portion of the $100,000 nonrecourse mortgage securing Sand Creek's office building. Other than the accounts payable and mortgage, Sand Creek does not owe any debts to other creditors.

   a. What is Laurel's initial tax basis in her LLC interest?
   b. What is Laurel's holding period in her interest?
   c. What is Sand Creek's initial basis in the contributed property?
   d. What is Sand Creek's holding period in the contributed property?

a. $280,000.
Laurel's basis in her LLC interest is made up of the $250,000 basis in the equipment (no depreciation was taken on the equipment prior to the contribution because it was acquired and contributed within the same calendar year) Laurel contributed, her $15,000 share of accounts payable that she guaranteed, and her $15,000 share of the nonrecourse mortgage securing Sand Creek's office building (15% x $100,000). Laurel's profits sharing ratio is used to allocate a portion of the mortgage to her because it is nonrecourse debt.

b. Laurel's holding period begins the day the LLC interest is acquired because the asset she contributed is not a capital or Section 1231 asset. The equipment is not a Section 1231 asset because it was used in a trade or business for one year or less.

c. $250,000.
The LLC takes a carryover basis in the contributed property.

d. Ten months.
Laurel's holding period is included in the LLC's holding period regardless of the nature of the property Laurel contributed.

40. [LO 2] {Planning} Harry and Sally formed the Evergreen partnership by contributing the following assets in exchange for a 50 percent capital and profits interest in the partnership:

Harry:	**Basis**	**Fair Market Value**
Cash	$ 30,000	$ 30,000
Land	100,000	120,000
Totals	$ 130,000	$ 150,000
Sally:		
Equipment used in a business	200,000	150,000
Totals	$ 200,000	$ 150,000

a. How much gain or loss will Harry recognize on the contribution?
b. How much gain or loss will Sally recognize on the contribution?
c. How could the transaction be structured a different way to get a better result for Sally?
d. What is Harry's tax basis in his partnership interest?
e. What is Sally's tax basis in her partnership interest?
f. What is Evergreen's tax basis in its assets?
g. Following the format in Exhibit 20-2, prepare a tax basis balance sheet for the Evergreen partnership showing the tax capital accounts for the partners.

a. $0.
Generally, partners recognize gain on property contributed to a partnership only when the cash they are deemed to receive from debt relief exceeds their basis in the partnership prior to the deemed distribution. Harry did not have any debt relief.

b. $0.
Partners may never recognize loss when property is contributed to a partnership even when they are relieved of debt.

c. *Sally should consider the possibility of selling the equipment to an unrelated party and contributing $150,000 in cash to the partnership in lieu of the equipment. By selling the property, she could recognize the $50,000 built-in loss on the equipment.*

d. *$130,000.*
Harry's basis in his partnership interest is simply the combined tax basis in the cash and land he contributed to the partnership.

e. *$200,000.*
Sally's basis in her partnership interest equals $200,000 basis in the equipment she contributed.

f. *$330,000.*
The partnership's basis in its assets equals the sum of the partners' bases in the cash ($30,000), in the land ($100,000), and in the equipment ($200,000).

g. *The partnership's tax basis balance sheet would appear as follows:*

Evergreen Partnership Tax Basis Balance Sheet	
	Tax Basis
Assets:	
Cash	*$30,000*
Equipment	*200,000*
Land	*100,000*
Totals	*$330,000*
Capital:	
Capital-Harry	*$130,000*
Capital-Sally	*200,000*
Totals	*$330,000*

43. [LO2] Kevan, Jerry, and Dave formed Albee LLC. Jerry and Dave each contributed $245,000 in cash. Kevan contributed the following assets:

Kevan:	**Basis**	**Fair Market Value**
Cash	$ 15,000	$ 15,000
Land*	120,000	440,000
Totals	$ 135,000	$ 455,000

*Nonrecourse debt secured by the land equals $210,000

Each member received a one-third capital and profits interest in the LLC.

a. How much gain or loss will Jerry, Dave and Kevan recognize on the contributions?
b. What is Kevan's tax basis in his LLC interest?
c. What tax basis do Jerry and Dave have in their LLC interests?
d. What is Albee LLC's tax basis in its assets?
e. Following the format in Exhibit 20-2, prepare a tax basis balance sheet for the Albee LLC showing the tax capital accounts for the members. What is Kevan's share of the LLC's inside basis?
f. If the lender holding the nonrecourse debt secured by Kevan's land required Kevan to guarantee 33.33 percent of the debt and Jerry to guarantee the remaining 66.67 percent of the debt when Albee LLC was formed, how much gain or loss will Kevan recognize?
g. If the lender holding the nonrecourse debt secured by Kevan's land required Kevan to guarantee 33.33 percent of the debt and Jerry to guarantee the remaining 66.67 percent of the debt when Albee LLC was formed, what are the members' tax bases in their LLC interests?

a. $0.
None of the members recognize gain because their debt relief was not in excess of their bases in their LLC interest prior to any debt relief. See table below:

Description	***Kevan***	***Each Other Member***	***Explanation***
(1) Basis in contributed Land	*$120,000*		
(2) Cash contributed	*$15,000*	*$245,000*	
(3) Nonrecourse mortgage in excess of basis in contributed land	*$90,000*		*Nonrecourse debt > basis is allocated only to Kevan*
(4) Remaining nonrecourse mortgage	*$40,000*	*$40,000*	*33.3% × [$210,000 – (3)]*
Basis immediately prior to debt relief	*$265,000*		
(5) Relief from mortgage debt	*($210,000)*		
Each member's initial tax basis in the LLC	*$55,000*	*$285,000*	*(1) + (2) + (3) + (4)+ (5)*

b. $55,000.
See table in part a. above.

c. *$285,000 each.*
See table in part a. above.

d. *$625,000.*
Albee, LLC takes a $120,000 carryover basis in the land Kevan contributes and a basis of $505,000 in the total cash the members contributed.

e. *Albee, LLC's tax basis balance sheet would appear as follows:*

Albee , ***LLC*** ***Tax Basis Balance Sheet***	
	Tax Basis
Assets:	
Cash	*$505,000*
Land	*120,000*
Totals	*$625,000*
Liabilities and Capital:	
Mortgage debt	*$210,000*
Capital-Kevan	*(75,000)*
Capital-Jerry	*245,000*
Capital-Dave	*245,000*
Totals	*$625,000*

Note that the members' tax capital accounts are equal to their bases in the LLC interests less their individual shares of LLC debt.

f. *$5,000. See table below:*

Description	***Kevan***	***Jerry***	***Dave***	***Explanation***
(1) Basis in contributed Land	*$120,000*			
(2) Cash contributed	*$15,000*	*$245,000*	*$245,000*	
(3) Mortgage Guarantee	*$70,000*	*$140,000*	*$0*	*33.33% x $210,000 for Kevan and 66.67% × $210,000 for Jerry*
(4) Basis immediately prior to debt relief	*$205,000*	*$385,000*	*$245,000*	*1+2+3*

(5) Relief from mortgage debt	*($210,000)*	*$0*	*$0*	
(6) Gain Recognized	*$5,000*	*$0*	*$0*	*(4) + (5)*
Each member's initial tax basis in the LLC	*$0*	*$385,000*	*$245,000*	*(4) + (5) + (6)*

g. Kevan's basis is $0, Jerry's basis is $385,000, and Dave's basis is $245,000. See the table in part f. above.

51. [LO 2] Last December 31, Ramon sold the 10 percent interest in the Del Sol Partnership that he had held for two years to Garrett for $400,000. Prior to selling his interest, Ramon's basis in Del Sol was $200,000 which included a $100,000 share of nonrecourse debt allocated to him.

a. What is Garrett's tax basis in his partnership interest?

b. If Garrett sells his partnership interests three months after receiving it and recognizes a gain, what is the character of his gain?

a. Garrett's basis in his partnership interest is equal to the $400,000 amount he paid for it plus his $100,000 share of partnership debt or $500,000.

b. Because Garrett purchased his partnership interest, his holding period for the interest begins on the date the interest was purchased. As a result, he only has a three-month holding period before the partnership interest is sold. This means his capital gain from the sale of his partnership interest will be short-term capital gain.

58. [LO 4] Turtle Creek Partnership had the following revenues, expenses, gains, losses, and distributions:

Sales revenue	$40,000
Long-term capital gains	$2,000
Cost of goods sold	($13,000)
Depreciation - MACRS	($3,000)
Amortization of organization costs	($1,000)
Guaranteed payments to partners for general management	($10,000)
Cash distributions to partners	($2,000)

a. Given these items, what is Turtle Creek's ordinary business income (loss) for the year?

b. What are Turtle Creek's separately stated items for the year?

Turtle Creek's ordinary business income and separately stated items are calculated and listed in the table below:

Description	*Amount*
Sales revenue	*$40,000*
Less:	
Cost of goods sold	*(13,000)*
Depreciation – MACRS	*(3,000)*
Amortization of organization costs	*(1,000)*
Guaranteed payments	*(10,000)*
a. Ordinary Business Income	*$13,000*
b. Separately Stated Items on Schedule K-1:	
Long-term capital gains	*$2,000*
Guaranteed payments	*$10,000*
Cash distributions	*$2,000*

Note that guaranteed payments must be separately disclosed to the partners that receive them, and cash distributions must be separately disclosed so that partners can reduce the tax basis of their partnership interests by the amount of the distributions.

59. [LO 4] Georgio owns a 20 percent profits and capital interest in Rain Tree LLC. For the current year, Rain Tree had the following revenues, expenses, gains, and losses:

Sales revenue	$70,000
Gain on sale of land (§1231)	$11,000
Cost of goods sold	($26,000)
Depreciation - MACRS	($3,000)
§179 deduction*	($10,000)
Employee wages	($11,000)
Fines and penalties	($3,000)
Municipal bond interest	$6,000
Short-term capital gains	$4,000
Guaranteed payment to Sandra	($3,000)

*Assume the §179 property placed in service limitation does not apply.

a. How much ordinary business income (loss) is allocated to Georgio for the year?
b. What are Georgio's separately stated items for the year?

a. *Georgio's allocation of ordinary business income is reflected in the table below:*

Description	***Total Amount***	***20% Allocated to Georgio***
Sales revenue	*$70,000*	
Less:		
Cost of goods sold	*(26,000)*	
Depreciation – MACRS	*(3,000)*	
Employee wages	*(11,000)*	
Guaranteed payments	*(3,000)*	
Ordinary Business Income	*$27,000*	*$5,400*

b. *Georgio's separately stated items are calculated in the table below:*

Description	***Total Amount***	***20% Allocated to Georgio***
Separately Stated Items on Schedule K-1:		
Section 1231 gains	*$11,000*	*$2,200*
Section 179 deduction	*(10,000)*	*(2,000)*
Short-term capital gains	*4,000*	*800*
*Municipal bond interest**	*6,000*	*1,200*
*Fines and penalties**	*(3,000)*	*(600)*

**Although these amounts are not included in Georgio's taxable income computation, they must be separately disclosed because they affect Georgio's tax basis in his LLC interest.*