PARTNERSHIP & S CORPORATION TAX REFERENCE GUIDE

Key Rules for 1065 and 1120-S Owners: Basis, Compensation, Deductions, and Audit Flags

1. CORE RULES FOR PARTNERSHIPS & S CORPORATIONS

Partnership / Form 1065 Basics:

- Partnerships are pass-through entities; income, deductions, and separately stated items flow to partners on Schedule K-1.
- General partners usually pay self-employment tax on active business income; limited partner and special-rule treatment depends on the facts.
- Guaranteed payments are generally deductible to the partnership and taxable to the partner.
- Partners track outside basis, capital, and debt basis to determine loss deductions and taxability of distributions.

S Corporation / Form 1120-S Basics:

- S corporations are pass-through entities; items flow to shareholders on Schedule K-1.
- Shareholder-employees who perform services must be paid reasonable compensation through payroll.
- Remaining profits may be distributed without self-employment tax, but wages are still subject to payroll tax.
- Shareholders track stock basis and loan basis to determine deductible losses and whether distributions are taxable.

2. COMMON TAX STRATEGIES & DOCUMENTATION RULES

- **Accountable Plan / Partner Expense Reimbursement:** S corporations can use accountable plans for shareholder-employees; partnerships can reimburse partners for substantiated partnership expenses under a written reimbursement policy. Keep receipts, business purpose, and timely substantiation.
- **Augusta Rule / IRC § 280A(g):** A business may rent the owner's home for legitimate meetings for up to 14 days per year; document fair-market rent, agenda, attendees, and actual business use.
- **Bonus Depreciation / Section 179:** Can accelerate write-offs for equipment, furniture, computers, machinery, and vehicles, subject to current-year rules and business-use limits.
- **Mixed-use vehicles, equipment, and other assets** are deductible or depreciable only to the extent of documented business use.
- **Business meals, travel, professional fees, and ordinary operating expenses** are generally deductible when properly documented.
- **Basis, at-risk, and passive activity limits** may restrict losses even when the expense itself is otherwise deductible.

3. ENTITY STRATEGY MATRIX

Strategy	Best Fit	Main Benefit	Key Rule
Partnership (1065)	Multiple owners, flexible economics	Special allocations and pass-through treatment	Track basis, debt basis, guaranteed payments, and distributions
S Corporation (1120-S)	Profitable active owners	Potential payroll tax savings on part of profits	Must run payroll and pay reasonable compensation
Accountable Plan / Partner Reimbursement	S corp owners and partners paying entity expenses personally	Entity deducts legitimate business expense; owner or partner is reimbursed	S corps follow accountable-plan rules; partnerships should substantiate reimbursed partner expenses
Augusta Rule IRC § 280A(g)	Owner uses residence for real business meetings	Business deducts rent; owner may exclude up to 14 rental days	Document fair-market rent, meeting purpose, agenda, and actual use
Bonus Depreciation / Sec. 179	Equipment, vehicles, and major asset purchases	Accelerates current-year write-offs	Placed-in-service and business-use rules apply; mixed-use limits matter

4. CRITICAL IRS AUDIT FLAGS & DISALLOWANCE TRIGGERS

- S corporation owners taking little or no reasonable salary.
- Deducting personal expenses or owner lifestyle costs as business write-offs.
- Claiming 100% business use for vehicles, phones, home office, or equipment without logs or support.
- Using the Augusta Rule without minutes, rent support, invoices, or real business meetings.
- Weak basis records causing improper loss deductions or taxable distributions.
- Partnership allocations or guaranteed payments that do not match the agreement or books.
- Missing payroll filings, late 1099 compliance, or poor bookkeeping.
- Claiming bonus depreciation or Section 179 without proof of placed-in-service date and business-use percentage.

General educational summary only. Rules vary by facts, entity structure, and state.