

2005

Shareholder's Instructions for Schedule K-1 (Form N-35)

Shareholder's Share of Income, Credits, Deductions, etc. (For Shareholder's Use Only)

(Section references are to the Internal Revenue Code, unless otherwise noted.)

General Instructions

Basis in Corporate Stock. — You are responsible for maintaining records to show the computation of your basis in stock of the corporation. Schedule K-1 provides you with information to help you make the computation at the end of each corporation tax year.

The initial basis of a resident shareholder in the stock of an S corporation and in any indebtedness of the corporation owed to the shareholder shall be determined in the manner provided under the Internal Revenue Code. The initial basis shall be determined as of the last to occur of the following:

1. The shareholder last became a resident of Hawaii;
2. The shareholder acquired the stock or the indebtedness of the corporation; or
3. The corporation became an S corporation.

The initial basis of a resident shareholder in the stock and indebtedness of an S corporation shall be adjusted after the above date in the manner and to the extent required by section 1011 except that, with respect to any taxable period during which the shareholder was a resident of Hawaii, any modification made (other than for income exempt from federal or State taxation) to the shareholder's income from the S corporation shall be taken into account; and any adjustments made pursuant to section 1367 for a taxable period during which Hawaii did not measure S corporation shareholder income by reference to the corporation's income shall not be taken into account. The basis of a resident shareholder in the stock of an S corporation shall be reduced by the amount allowed as a loss or deduction, not to exceed the combined adjusted basis of the shareholder in the stock and indebtedness of the corporation.

The initial basis of a nonresident shareholder in the stock of an S corporation and in any indebtedness of the corporation to the shareholder shall be zero. The initial basis shall be determined as of the last to occur of the following:

1. The shareholder acquired the stock or indebtedness of the corporation;
2. The corporation became an S corporation; or
3. The shareholder last became a nonresident of Hawaii.

The initial basis of a nonresident shareholder in the stock and indebtedness of an S corporation shall be adjusted after the above date in the manner provided in section 1367, except that adjustments to basis shall be limited to the income attributable to Hawaii and taxable to the nonresident shareholder for Hawaii income tax purposes. In computing income attributable to Hawaii, any modification made for income exempt from federal or Hawaii taxation shall be taken into account.

Nonresident Shareholders.—Shareholders who are not Hawaii residents will be asked by the S corporation to complete and sign an agreement (Schedule NS) stating that the shareholder agrees to file a Hawaii net income tax return, make timely payments of taxes due, and to be subject to personal jurisdiction in the State of Hawaii for purposes of the collection of unpaid income tax. Shareholders for whom an agreement is not obtained and filed by the S corporation on its timely filed return are subject to withholding by the S corporation of 8.25% of the shareholder's income attributed to Hawaii. This amount, shown on line 12r, may be claimed as a credit on a nonresident Hawaii net income tax return (Form N-15) subsequently filed by the shareholder or may take the place of filing a Hawaii return by the nonresident share-

holder. No credit will be allowed for this amount until the S corporation has filed and paid the amount due. Shareholders for whom an agreement is obtained and filed as required may be included in a composite net income tax return filed on behalf of an S corporation's nonresident shareholders.

Errors. — If you believe the corporation has made an error on your Schedule K-1, notify the corporation and ask for a corrected Schedule K-1. Do not change any items on your copy. Be sure that the corporation sends a copy of the corrected Schedule K-1 to the Hawaii Department of Taxation.

Specific Instructions

Name, Address, and Identifying Number. — Your name, address, and identifying number, the corporation's name, address, and identifying number, and item A should have been entered. If the corporation is involved in a tax shelter, item B will be completed. The corporation completes item C, if applicable.

Lines 1 through 22

If you are an individual shareholder, take the amounts shown in column (b) and the total sum of amounts shown in columns (b) and (c) and enter them on the appropriate worksheet and/or lines of your tax return. If you are an estate or trust, report the amounts shown in columns (b) and/or (c) as instructed on Form N-40, Hawaii Fiduciary Income Tax Return.

The amounts on lines 1 through 22 show your pro rata share of ordinary income, loss, deductions, credits, and other information from all corporate activities. These amounts do not take into account limitations on losses or other items that may have to be adjusted because of your adjusted basis in stock and debt in the corporation, the at-risk limitations under section 465, the passive activity limitations of section 469, or any other limitations that must be taken into account at the shareholder level in figuring taxable income (e.g., the section 179 expense limitation (further limited for Hawaii purposes to \$25,000)). These limitations are discussed in the instructions for federal Schedule K-1 (Form 1120S). If you are an individual shareholder and your share of pro rata items are affected by any limitations, adjust the amounts before you enter the amounts on your return.

Caution: If you have losses, deductions, credits, etc., from a prior year that were not deductible or useable because of certain limitations, such as the at-risk rules, they may be taken into account in determining your income, loss, etc., for this year. However, do not combine the prior year amounts with any amounts shown on this Schedule K-1 to get a net figure to report on your return. Instead, report the amounts on your return on a year-by-year basis.

Line-by-Line Instructions

For Form N-11 filers, most of your pro rata share of ordinary income, loss, deductions, etc. are included in federal adjusted gross income (federal AGI). If the total sum of the amounts in columns (b) and (c) of your Hawaii Schedule K-1 (Form N-35) and the amounts in your federal Schedule K-1 (Form 1120S) are different, make the necessary adjustments in the Hawaii Additions Worksheet and/or Hawaii Subtractions Worksheet of the Forms N-11/N-12 Instructions.

Income

Line 1. Ordinary income (loss) from trade or business activities.—The amount reported on line 1 is your share of the ordinary income (loss) from trade or business activities of the corporation. Generally, where you report the amount depends on whether

the amount is from an activity that is a passive activity to you. Refer to the federal Shareholder's Instructions for Schedule K-1 (Form 1120S) for the amount to report. Include amount on Form N-12, line 18 or on Form N-15, line 17.

Line 2. Net income (loss) from rental real estate activities.—Generally, the income (loss) reported on line 2 is a passive activity amount for all shareholders. If there are exceptions, then refer to the federal Shareholder's Instructions for Schedule K-1 (Form 1120S). Include the amount on Form N-12, line 16b or on Form N-15, line 17.

Line 3. Net income (loss) from other rental activities.—The amount on line 3 is a passive activity amount for all shareholders. Report a loss following the instructions for federal Form 8582. Report income on Form N-12, line 16b or on Form N-15, line 17.

Line 4. Portfolio income (loss).—Income or loss referred to as "portfolio" income or loss is not part of a passive activity subject to the rules of section 469. Portfolio income includes income not derived in the ordinary course of a trade or business from interest, dividends, annuities, or royalties, and gain or loss on the sale of property that produces these types of income or is held for investment.

Line 4a. Interest.—Include the amount in the Interest Worksheet in the Forms N-11/N-12 Instructions or Form N-15 Instructions.

Line 4b. Ordinary Dividends.—Include the amount on line 9 of Form N-12 or N-15.

Line 4c. Royalties.—Include the amount on Form N-12, line 18 or on Form N-15, line 17.

Line 4d. Net short-term capital gain (loss).—Include the amount in the Capital Gain/Loss Worksheet in the Forms N-11/N-12 Instructions or Form N-15 Instructions.

Line 4e. Net long-term capital gain (loss).—Include the amount in the Capital Gain/Loss Worksheet in the Forms N-11/N-12 Instructions or Form N-15 Instructions.

Line 5. Net section 1231 gain (loss) (other than due to casualty or theft).—Section 1231 gain or loss is reported on line 5. The corporation will identify the activity to which the section 1231 gain (loss) relates in the line 23 Supplemental Information section of Schedule K-1. If the amount on line 5 is from a rental activity, the section 1231 gain (loss) is a passive activity amount. Likewise, if the amount relates to a trade or business activity and you did not materially participate in the activity, the section 1231 gain (loss) is a passive activity amount. Refer to the federal Shareholder's Instructions for Schedule K-1 (Form 1120S) for applicable amount to report. Include the applicable gain or loss on Schedule D-1, line 2.

Line 6. Other income (loss).—Amounts on line 6 are other items of income, gain, or loss not included on lines 1 through 5. The corporation should give you a description and the amount of your share for each of these items. Include the amount of income (loss) on the applicable line of your return. Refer to the federal Shareholder's Instructions for Schedule K-1 (Form 1120S) for more information.

Deductions

Line 7. Charitable contributions.—The corporation will give you a schedule that shows the amount of contributions subject to the 50%, 30%, and 20% limitations. Refer to the federal Shareholder's Instructions for Schedule K-1 (Form 1120S) for the amount to report. Include the amount in the Worksheet A-4 - Gifts to Charity in the Forms N-11/N-12 Instructions or Worksheet PY-4 or NR-4 in the Form N-15 Instructions.

Line 8. IRC section 179 expense deduction.— Include this amount along with the total cost of section 179 property placed in service during the year from other sources, to complete federal Form 4562, Depreciation and Amortization. If the amount is allocable to a passive activity from the corporation, report the amount following the instructions for federal Form 8582. If the amount is not a passive activity deduction, include it on Form N-12, line 18 or on Form N-15, line 17. Maximum Hawaii deduction is \$25,000.

Line 9. Deductions related to portfolio income (loss).—Amounts on line 9 are the expenses (other than investment interest expense and section 212 expenses from a REMIC) paid or incurred to produce portfolio income. Generally, include the amounts in the Worksheet A-6 - Miscellaneous Deductions in the Forms N-11/N-12 Instructions or Worksheet PY-6 or NR-6 in the Form N-15 Instructions. These deductions are not taken into account in figuring your passive activity loss for the year.

Line 10. Other deductions.—Amounts on line 10 are other deductions not included on lines 7, 8, and 9. The corporation should give you a description and your share of each of the expense items. Include the amount of deduction on the applicable line of your return. Refer to the federal Shareholder's Instructions for Schedule K-1 (Form 1120S) for more information.

Investment Interest

If the corporation paid or accrued interest on debts properly allocable to investment property, the amount of interest you are allowed to deduct may be limited. For more information and the special provisions that apply to investment interest expense, see Form N-158, Investment Interest Expense Deduction, and federal Publication 550, Investment Income and Expenses.

Line 11a. Interest expense on investment debts.—Include the amount on Form 158 along with your investment interest expense from other sources to determine how much of your total investment interest is deductible.

Lines 11b(1) and 11b(2). Investment income and investment expenses.—Use the amounts on these lines to determine the amount to enter on line 1 of Form N-158.

Caution: The amounts shown on lines 11b(1) and 11b(2) include only investment income and expenses reported on lines 4a, 4b, 4c, and 9 of this Schedule K-1. If applicable, the corporation will have listed in the line 23 Supplemental Information section any other items of investment income and expenses reported elsewhere on this Schedule K-1. Be sure to take these amounts into account, along with the amounts on lines 11b(1) and 11b(2) and your investment income and expenses from other sources when figuring the amount to enter on line 1 of Form N-158.

Credits

All filers should complete the appropriate forms to claim their pro rata share of credits. **Also attach a copy of this Schedule K-1 to the Hawaii net income tax return you file to support your credit.**

Line 12a. Fuel Tax Credit for Commercial Fishers.—Figure your credit on Form N-163.

Line 12b. Total cost of qualifying property for the Capital Goods Excise Tax Credit.—Figure your credit on Form N-312. See Form N-312 and Tax Information Release No. 2001-4 for additional information.

Line 12c. Amounts needed to claim the Enterprise Zone Tax Credit.—There should be attached to this

Schedule K-1 a copy of Form N-756A showing your share of the corporation's amounts needed to claim the credit. If the form is not attached, contact your corporation as you will need to attach a copy of the form to the Hawaii net income tax return you file in order to receive the credit. Figure your credit on Form N-756.

Line 12d. Hawaii Low-Income Housing Tax Credit.—Hawaii's low-income housing tax credit is equal to 50% (30% for property placed in service prior to July 1, 2005) of the federal credit for qualified buildings located in the State of Hawaii. Figure your credit on Form N-586.

Note: You may apply this nonrefundable credit only after all other credits except the High Technology Investment Tax Credit and the Technology Infrastructure Renovation Tax Credit have been applied against your Hawaii income tax liability.

Line 12e. Credit for Employment of Vocational Rehabilitation Referrals.—Your share of the credit is shown on this line. Refer to Form N-884 for further information.

Lines 12f. Motion Picture and Film Production Income Tax Credit.—Use the amounts shown to figure your credit on Form N-316.

Line 12g. Renovation costs for the Technology Infrastructure Renovation Tax Credit.—Your share of the total renovation costs to be used to claim this credit is shown on this line.

Line 12h. High Technology Business Investment Tax Credit.—Your share of the High Technology Business Investment Tax Credit is shown on line 12h. Use Form N-318 to claim this credit.

Line 12i. Tax Credit for Research Activities.—Your share of the Tax Credit for Research Activities is shown on line 12i. Use Form N-319 to claim this credit.

Line 12j. Individual Development Account Contributions Tax Credit.—Enter your share of this credit on Form N-320, line 5.

Lines 12k. Hotel Construction and Remodeling Tax Credit.—Enter your share of the qualifying costs on the appropriate lines of Form N-314.

Line 12l. Total qualifying costs for the Drought Mitigating Water Storage Facility Tax Credit.—Your share of the total qualifying costs to be used to claim this credit is shown on this line. Figure your credit on Form N-328.

Line 12m. Credit for School Repair and Maintenance.—Your share of the Credit for School Repair and Maintenance is shown on line 12m. Use Form N-330 to claim this credit.

Line 12n. Ethanol Facility Tax Credit.—Attach a copy of this Schedule K-1 to the Hawaii net income tax return you file to substantiate the amount of your share of the credit. Enter your share of this credit on Form N-324, line 8.

Line 12o. Renewable Energy Technologies Income Tax Credit.—There should be attached to this Schedule K-1 a copy of Form N-334A showing the type of system and your share of the corporation's amounts needed to claim the credit. If the form is not attached, contact your corporation as you will need to attach a copy of the form to the Hawaii net income tax return you file in order to receive the credit. Use Form N-334 to claim this credit.

Line 12p. Ko Olina Resort and Marina Attractions and Educational Facilities Tax Credit.—If there is an amount on this line, see Form N-335 for information.

Line 12q. Credit for Hawaii income tax withheld

on Form N-288.—If there is an amount on line 12q, include this amount on Schedule CR, line 22a and attach a copy of this Schedule K-1 to your Form N-11, Form N-12, or Form N-15.

Line 12r. Credit for Hawaii income tax withheld on Form N-4 (Nonresident shareholders only).—If there is an amount on line 12r, include this amount on Form N-15, line 47.

Line 12s. Pro rata share of net income tax paid (Resident and part-year resident shareholders only).—A resident or a part-year resident shareholder shall be considered to have paid a tax imposed on the shareholder in an amount equal to the shareholder's pro rata share of any net income tax paid by the S Corporation to a state which does not measure the income of S corporation shareholders by the income of the S corporation. Include amount in Other State and Foreign Tax Credit Worksheet in the Forms N-11/N-12 Instructions or in the Form N-15 Instructions.

Other

Line 13. Property distributions.—Reduce the basis of your stock in the corporation by the distributions on line 13. If these distributions exceed the basis of your stock, the excess is treated as gain from the sale or exchange of property and is reported in the Capital Gain/Loss Worksheet in the Forms N-11/N-12 Instructions or in the Form N-15 Instructions.

Line 14. Tax exempt interest income.—Generally, you must increase the basis of your stock in the corporation by the amount shown.

Line 15. Other tax exempt income.—Generally, you must increase the basis of your stock in the corporation by the amount shown.

Line 16. Nondeductible expenses.—The nondeductible expenses paid or incurred by the corporation are not deductible on your tax return. Generally, you must decrease the basis of your stock in the corporation by this amount.

Line 17. Amount of loan repayments for "Loans from Shareholders".—If the line 17 payments are made on indebtedness with a reduced basis, the repayments result in income to you to the extent the repayments are more than the adjusted basis of the loan.

Lines 18. Adjustments.—Report your pro rata share of adjustments as applicable.

Line 19. Interest penalty on early withdrawal of savings.—The amount of line 19 is included on the "Other adjustments" line of the Hawaii Subtractions Worksheet of the N-11 Instructions (attach an explanation to Form N-11) or on Form N-12, line 27.

Recapture of Tax Credits

Line 20. Recapture of Hawaii Low-Income Housing Tax Credit.—Report your pro rata share of recapture of the Hawaii Low-Income Housing Tax Credit from section 42(j)(5) partnerships and other sources. Complete Form N-586. See Form N-587, Low-Income Housing Credit Disposition Bond, for an alternative to credit recapture.

Line 21. Capital Goods Excise Tax Credit Properties.—You should receive a completed copy of Form N-312, Part II from the corporation. Use this information to determine the amount of credit recapture on Form N-312.

Line 22. Recapture of High Technology Business Investment Tax Credit.—Report your pro rata share of recapture of the High Technology Business Investment Tax Credit on Form N-318.