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# Tax Information on S Corporations

For use in preparing  
**1995** Returns



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## Important Changes for 1995

**Caution.** As this publication was being prepared for print, Congress was considering tax law changes that could affect your 1995 tax return and 1996 estimated taxes. This includes changes to capital gains and losses. See Publication 553, *Highlights of 1995 Tax Changes*, for further developments. Information on these changes will also be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

**Health insurance for self-employed persons.** The 25% deduction for health insurance costs for self-employed persons has

been reinstated for tax years beginning after 1993.

The deduction increases to 30% for tax years beginning after 1994. See *Health and accident insurance* under *Figuring Shareholder Taxable Income*.

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## Introduction

An eligible domestic corporation can avoid double taxation (once to the corporation and again to the shareholders) by electing to be treated as an S corporation under the rules of Subchapter S of the Internal Revenue Code. In this way, the S corporation passes its items of income, loss, deduction, and credits through to its shareholders to be included on their separate returns. Individual shareholders may benefit from a reduction in their taxable income during the first years of the corporation's existence when it may be operating at a loss.

This publication discusses how to become an S corporation, how an S corporation may be taxed, how income is distributed to shareholders, and how to terminate an S corporation.

### Useful Items

You may want to see:

#### Publication

- 15** Circular E, Employer's Tax Guide
- 334** Tax Guide for Small Business
- 535** Business Expenses
- 538** Accounting Periods and Methods
- 542** Tax Information on Corporations
- 544** Sales and Other Dispositions of Assets
- 550** Investment Income and Expenses
- 551** Basis of Assets
- 583** Starting a Business and Keeping Records
- 908** Tax Information on Bankruptcy
- 925** Passive Activity and At-Risk Rules

#### Form (and Instructions)

- 1120** U.S. Corporation Income Tax Return
- 1120S** U.S. Income Tax Return for an S Corporation
- 1128** Application To Adopt, Change, or Retain a Tax Year
- 2553** Election by a Small Business Corporation
- 6251** Alternative Minimum Tax—Individuals
- 8082** Notice of Inconsistent Treatment or Amended Return (Administrative Adjustment Request (AAR))
- 8716** Election To Have a Tax Year Other Than a Required Tax Year
- 8752** Required Payment or Refund Under Section 7519

**Ordering publications and forms.** To order free publications and forms, call 1-800-TAX-FORM (1-800-829-3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address.

If you have access to a personal computer and a modem, you can also get many forms and publications electronically. See *How To Get Forms and Publications* in your income tax package for details.

**Telephone help.** You can call the IRS with your tax question Monday through Friday during regular business hours. Check your telephone book for the local number or you can call **1-800-829-1040**.

**Telephone help for hearing-impaired persons.** If you have access to TDD equipment, you can call **1-800-829-4059** with your tax question or to order forms and publications. See your tax package for the hours of operation.

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## Becoming an S Corporation

A corporation can become an S corporation if:

- 1) It meets the requirements of S corporation status,
- 2) All its shareholders consent to S corporation status,
- 3) It uses a permitted tax year, or elects to use a tax year other than a permitted tax year, explained later, and
- 4) It files Form 2553 to indicate it chooses S corporation status.

### Requirements of an S Corporation

To qualify for S corporation status, a corporation must meet *all* the following requirements:

- 1) It must be a domestic corporation that is either organized in the United States or organized under federal or state law. The term "corporation" includes joint-stock companies, insurance companies, and associations.
- 2) It must have only one class of stock. See *One Class of Stock*, later.
- 3) It must have no more than 35 shareholders. See *Counting Shareholders*, later.
- 4) It must have as shareholders only individuals, estates (including estates of individuals in bankruptcy), and certain trusts. See *Trusts*, later. Partnerships and corporations cannot be shareholders in an S corporation.
- 5) It must have no nonresident alien shareholders.

#### Certain domestic corporations ineligible.

Certain domestic corporations are ineligible to elect S corporation status. They are:

- 1) A member of an affiliated group of corporations. Generally, an affiliated group means one or more chains of corporations connected through stock ownership with a common parent corporation that is also part of the group where:
  - a) The common parent directly owns stock that possesses at least 80% of the total voting power of the stock of at least one of the corporations,
  - b) The stock the common parent owns has a value equal to at least 80% of the total value of the stock of that same corporation, and
  - c) One or more of the other corporations in the group directly owns at least 80% of the total voting power of the stock and at least 80% of the total value of the stock in each of the other corporations (except the common parent) in the group.

See *Subsidiaries*, later, for exceptions to this rule. For purposes of determining whether a corporation is a member of an affiliated group, certain preferred stock is not taken into account.

- 2) A **DISC** (Domestic International Sales Corporation) or former DISC.
- 3) A corporation that takes the Puerto Rico and possessions tax credit for doing business in a United States possession.
- 4) A financial institution that is a bank, including mutual savings banks, cooperative banks, and domestic building and loan associations.
- 5) An insurance company taxed under Subchapter L of the Internal Revenue Code.

### One Class of Stock

For tax years beginning before May 28, 1992, an S corporation had more than one class of stock if the rights in the profits and assets of the corporation were not identical for all holders of the outstanding stock. Differences in voting rights were allowed.

The one-class-of-stock rules discussed here apply to corporate tax years beginning after May 27, 1992. However, an S corporation and its shareholders can apply these rules to prior years. For more information, see *Effective date*, later in this discussion.

A corporation that has more than one class of stock does not qualify as an S corporation. A corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Stock can have differences in voting rights and still be considered one class of stock. For example, a corporation can have voting and nonvoting common stock, a class of stock that can vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

**Identical rights to distribution and liquidation proceeds.** Generally, the determination

of whether stock has identical rights to distribution and liquidation proceeds is made based on the governing provisions of the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds.

A commercial contractual agreement, such as a lease or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds, and is not a governing provision unless a principal purpose of the agreement is to get around this one-class-of-stock provision. Although a corporation is not treated as having more than one class of stock as long as its governing provisions provide for identical distribution and liquidation rights, the tax effect of any distribution that differs in timing or amount will depend on the facts and circumstances.

State laws may require a corporation to pay or withhold state income taxes on behalf of some or all of the corporation's shareholders. These laws are disregarded in finding whether all outstanding shares have identical rights to distribution and liquidation proceeds if, when the constructive distributions resulting from the payment or withholding of taxes by the corporation are taken into account, the shares have identical rights. A difference in timing between the constructive distributions and the actual distributions to the other shareholders does not cause the corporation to be treated as having more than one class of stock.

#### **Buy-sell and redemption agreements.**

Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded for the one-class-of-stock rules. Also disregarded are buy-sell agreements, redemption agreements, and agreements restricting the transferability of stock unless:

- 1) A principal purpose of the agreement is to get around the one-class-of-stock rules, and
- 2) The agreement establishes a purchase price that, at the time of the agreement, is significantly above or below the fair market value of the stock.

**Treatment of straight debt.** An instrument or obligation that is straight debt is generally not treated as a second class of stock. The term "straight debt" means any written unconditional promise to pay a fixed amount on demand or on a specified date if:

- 1) The interest rate and interest payment dates are not contingent on profits, the borrower's discretion, or similar factors,
- 2) The debt cannot be converted into stock or any other equity interest of the S corporation, and
- 3) The creditor is an individual (other than a nonresident alien), an estate, or a trust eligible to hold stock in an S corporation.

**Subordination.** An obligation that is subordinated (placed in a lower position) to other

debt of the corporation is not prevented from qualifying as straight debt.

#### ***Straight debt modified or transferred.***

An obligation that originally qualifies as straight debt ceases to qualify if:

- 1) The obligation is materially modified so that it no longer satisfies the definition of straight debt, or
- 2) It is transferred to a third party who is not an eligible shareholder in the S corporation.

**Second class of stock.** Instruments, obligations, or other arrangements issued by a corporation may be treated as a second class of stock in the following two situations:

- 1) They are treated as equity.
- 2) They are call options or warrants.

**Treated as equity.** An instrument, obligation, or other arrangement, regardless of whether it is called a debt, is treated as a second class of stock if:

- 1) It constitutes equity or otherwise results in the holder being the owner of stock under federal tax law principles, and
- 2) A principal purpose of the transaction is to get around the one-class-of-stock rules or the limitations on eligible shareholders listed earlier under *Requirements of an S Corporation*.

See *Treatment of straight debt*, earlier, and section 1.1361-1(l) of the Income Tax Regulations for certain exceptions.

**Call options and warrants.** A call option, warrant, or similar instrument is treated as a second class of stock if, taking into account all facts and circumstances:

- 1) It is substantially certain to be exercised, and
- 2) It has a strike price substantially below the fair market value of the underlying stock on the date the call option is issued.

See section 1.1361-1(l) of the regulations for exceptions and more information.

**Not treated as outstanding stock.** The general requirement for having only one class of stock is that all outstanding shares of stock have identical rights to distribution and liquidation proceeds. Exceptions to the requirement that all outstanding shares of stock are taken into account apply to:

- 1) Restricted stock, and
- 2) Deferred compensation plans.

**Restricted stock.** Stock that is issued in connection with the performance of services, and that is substantially nonvested, is generally not treated as outstanding stock. The holder of that stock is not treated as a shareholder unless he or she makes an election to

include in income the fair market value of the stock at the time of the transfer minus the amount paid for the stock. Whether that nonvested stock is treated as a second class of stock depends on the facts and circumstances.

**Deferred compensation plans.** An instrument, obligation, or arrangement is not treated as outstanding stock if:

- 1) It does not convey the right to vote,
- 2) It is an unfunded and unsecured promise to pay money or property in the future,
- 3) It is issued to an employee or independent contractor in connection with the performance of services for the corporation,
- 4) It is not excessive by reference to the services performed, and
- 5) It is issued pursuant to a plan under which the employee or independent contractor is not taxed currently on income.

**Unissued stock.** Authorized but unissued stock and treasury stock are not considered in determining if a corporation has more than one class of stock. Nor is special stock issued to the Federal Housing Administration considered when making this determination. The existence of outstanding options, warrants to acquire stock, or convertible debentures will not, by itself, be considered a second class of stock.

**Effective date.** The rules for one class of stock generally apply to tax years beginning after May 27, 1992. However, they do not apply to an instrument, obligation, or arrangement issued or entered into before May 28, 1992, and not materially modified after that date. Nor do they apply to a buy-sell agreement, redemption agreement, or agreement restricting transferability entered into before May 28, 1992, or a call option or similar instrument issued before that date, provided the agreement, option, or similar instrument was not materially modified after that date. In addition, an S corporation and its shareholders can apply these rules to prior tax years.

#### **Counting Shareholders**

An S corporation cannot have more than 35 shareholders. When counting shareholders, the following rules apply:

- 1) Count the individual, estate, or other person who is considered the shareholder if the stock is actually held by a trust. See *Trusts*, next. Do not count the trust itself as a shareholder.
- 2) Count a husband and wife, and their estates, as one shareholder, even if they own stock separately.
- 3) Otherwise, count everyone who owns any stock, even if the stock is owned jointly with someone else.

## Trusts

The following trusts, other than foreign trusts, can be shareholders of an S corporation:

- 1) A trust that is treated as entirely owned by an individual who is a United States citizen or resident. The individual, not the trust, is treated as the shareholder.
- 2) A trust that qualified under (1) immediately before the owner's death, and continues to exist after the owner's death, can continue to be an S corporation shareholder for stock held by the trust when the owner died. This is valid only for a period of 60 days, beginning on the day of the owner's death. However, if the entire corpus of the trust is included in the owner's gross estate, the 60-day period becomes a 2-year period. The owner's estate is treated as the shareholder.
- 3) A trust created primarily to exercise the voting power of stock transferred to it. Each beneficiary of the trust is treated as a shareholder.
- 4) Any trust that stock is transferred to under the terms of a will, but only for 60 days, beginning with the day the stock was transferred to the trust. The estate of the person leaving the will is treated as the shareholder.

**Ineligible trust.** A trust that qualifies as an IRA cannot be a shareholder in an S corporation.

**Qualified subchapter S trusts.** The beneficiaries of certain other trusts can choose to have their trusts qualify as a trust described in (1), above. These trusts are known as "qualified subchapter S trusts" (QSST). The beneficiary of a QSST can elect to have the trust qualify as a shareholder of an S corporation.

A trust is a QSST if:

- 1) All trust income is or must be distributed currently to one beneficiary (the "income beneficiary"),
- 2) The income beneficiary is a citizen or resident of the United States, and
- 3) The terms of the trust require all of the following:
  - a) Once a person becomes the income beneficiary, that person remains the income beneficiary until death.
  - b) While an income beneficiary is alive, the corpus (principal or capital) of the trust can be distributed only to that beneficiary.
  - c) The income beneficiary's right to receive trust income will end when the beneficiary dies or when the trust terminates, whichever occurs first.
  - d) If the trust is terminated during an income beneficiary's lifetime, all trust assets will be distributed to that beneficiary.

For purposes of this election, a substantially separate and independent share of a trust is treated as a separate trust.

**Election to qualify as a shareholder.** A beneficiary (or legal representative) makes the election by signing and filing a statement with the IRS Service Center where the S corporation files its income tax return. The statement must:

- 1) Give the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the S corporation,
- 2) Identify that it is an election being made under IRC Section 1361(d)(2),
- 3) Specify the effective date of the election (not earlier than 15 days and two months before the date on which the election is filed), and
- 4) Provide all information necessary to show that the current income beneficiary is entitled to make the election.

## Subsidiaries

Generally, an S corporation cannot have a subsidiary that would cause it to be a member of an affiliated group of corporations. However, this rule may not apply if the subsidiary is inactive, a former DISC, or a foreign corporation.

**Inactive subsidiary.** An inactive subsidiary is one that, during any period in a tax year:

- 1) Has not begun business at any time by the close of that period, and
- 2) Does not have gross income for that period.

**Former DISC or foreign corporation as a subsidiary.** A corporation that holds a foreign corporation or former DISC as a subsidiary is not eligible to be an S corporation, unless it qualified under the "grandfather rules" of the Subchapter S Revision Act of 1982.

## Shareholder Consents

The corporation's election of S corporation status is valid only if all shareholders consent to the election. A shareholder's consent is binding and cannot be withdrawn after a valid election is made by the corporation.

**Form of consent.** Shareholders can consent by providing the required information on Form 2553 and signing in the appropriate space.

The shareholder can also consent by signing a separate written consent statement, under penalties of perjury, which should be attached to Form 2553. The separate consent should provide the following information:

- 1) The name, address, and taxpayer identification number of the corporation,
- 2) The name, address, and taxpayer identification number of the shareholder,
- 3) The number of shares of stock owned by the shareholder and the date or dates acquired,
- 4) The day and month of the end of the shareholder's tax year, and

- 5) A statement that the shareholder consents to the election of S corporation status.

The consents of all shareholders can be included in one statement. The corporation's election of S corporation status is invalid if any consent is not filed on time. However, if the corporation's election would be valid except for the failure of any shareholder to file a consent on time, an extension of time to file the consent can be requested. The request for an extension of time to file should be sent to the Internal Revenue Service Center where Form 2553 was filed.

The time for filing a consent can be extended if:

- 1) It is shown to the satisfaction of the IRS that there was reasonable cause for the failure to file the consent and that the government's interest will not be jeopardized by treating the election of S corporation status as valid, and
- 2) The request for the extension is made within a reasonable period of time under the circumstances.

Consents must be filed within the extended period by all persons:

- 1) Who were shareholders at any time beginning with the date of the invalid election and ending on the date the extension of time is granted, and
- 2) Who have not previously consented to the election.

**Who must consent.** Each person who is a shareholder at the time Form 2553 is filed must consent. If the consent is filed before the 16th day of the 3rd month of the year for which it is to be effective, all shareholders in the corporation who held stock on any day in the tax year before the date Form 2553 is filed must also consent.

An election made before the 16th day of the 3rd month of the tax year is considered made for the following tax year if one or more of the persons who held stock in the corporation during the tax year and before the election was made did not consent to the election. An election made after the 15th day of the 3rd month but before the end of the tax year will also be considered as made for the following tax year.

**Co-owners.** Each co-owner, tenant by the entirety, tenant in common, and joint tenant must consent. If stock is owned as community property or if income from the stock is community property, both husband and wife must consent.

**Minors.** The consent of a minor must be made by the minor or his or her legal representative (or a natural or an adoptive parent of the minor if no legal representative has been appointed).

**Estates.** The consent of an estate holding stock in an S corporation must be made by an executor or administrator of the estate.

**Trusts.** The consent of a qualified trust holding stock in a newly electing S corporation must be made by the person who is treated as

a shareholder to determine whether the corporation meets the S corporation requirements. If a husband and wife have a community interest in the trust, both must consent. See *Trusts*, earlier, under *Requirements of an S Corporation*.

## Form 2553—Electing S Corporation Status

To be treated as an S corporation, a corporation must file Form 2553 to indicate its election of S corporation status. The corporation must qualify as an S corporation when it files its Form 2553. The Form 2553 should also be used to file shareholder consents and to select a tax year.

Form 2553 should be filed with the Internal Revenue Service Center shown in the instructions to the form.

**When to file Form 2553.** In general, the election of S corporation status is effective for a tax year if Form 2553 is filed:

- 1) Any time during the previous tax year, or
- 2) By the 15th day of the 3rd month of the tax year to which the election is to apply.

## Tax Year

The term “tax year” is the annual accounting period that is used for keeping records and reporting income and expenses. It is either a calendar year or a fiscal year.

**Permitted tax year.** A permitted tax year is a calendar year, or any other accounting period for which the corporation establishes a substantial business purpose to the satisfaction of the IRS. In addition, an S corporation can elect under section 444 to have a tax year other than the permitted tax year.

A corporation electing S corporation status does not need IRS approval to choose a calendar year as its tax year if all its principal shareholders either use the calendar year as their tax year or adopt the calendar year as their tax year at the same time as the corporation makes the choice. An electing S corporation should use Form 2553 to request a tax year other than a calendar year, or to make the section 444 election.

**Substantial business purpose.** A substantial business purpose exists if the corporation’s requested year is a natural business year, or if the requested year satisfies an ownership tax year test. Both the natural business year and the ownership tax year tests are discussed under *Business Purpose Tax Year* in Publication 538. If neither of these apply, the corporation can establish a business purpose as discussed next.

Both tax factors and nontax factors must be considered in determining whether you have a substantial business purpose. A nontax factor for a substantial business purpose is the annual cycle of your business activity.

Significant weight is given to tax factors. A prime consideration in permitting the use of a different tax year is whether it would create a

substantial distortion of income. Examples of distortion of income are:

- 1) Deferring a substantial portion of income, or shifting a substantial portion of deductions, from one year to another so as to reduce tax liability,
- 2) Causing a similar deferral or shifting for any other person, such as a shareholder, and
- 3) Creating a short period in which there is a substantial net operating loss.

For more information, see Publication 538.

**Change of tax year.** An S corporation should file **Form 1128** to apply for permission to change its tax year to a year other than a year ending December 31. This form should be filed by the 15th day of the 2nd calendar month after the close of the short tax year. This short tax year begins on the first day after the end of the corporation’s present tax year and ends on the day before the opening date of its new tax year.

**User fee.** The corporation must submit a user fee with Form 1128. Form 1128 and the user fee should be filed with:

Associate Chief Counsel (Domestic)  
Internal Revenue Service  
Attention: CC:DOM:CORP:T  
P.O. Box 7604  
Benjamin Franklin Station  
Washington, DC 20044

The package should be marked “Ruling Request Submission.”

The application should contain all the requested information. It should show that there is a business purpose for the change. The deferral of income to shareholders generally will not be treated as a business purpose.

**Note.** Form 1128 should not be used to request a tax year for or during the first year the corporation elects to be an S corporation.

User fees are charged by the Internal Revenue Service for requests for changes in accounting periods and methods, and for certain tax rulings and determination letters. For more information and a schedule of fees, see Publication 1375, *Procedures for Issuing Rulings*.

**Section 444 election.** S corporations can elect, under section 444, to use a tax year that is different from the permitted tax year. Certain restrictions apply to this election. The S corporation can make this election if:

- 1) It is not a member of a tiered structure (see section 1.444-2T of the Income Tax Regulations).
- 2) It has not previously had a section 444 election in effect, and
- 3) It elects a year that meets the deferral period requirement.

Generally, an S corporation can make a section 444 election only if the tax year it wants to use results in a deferral period of 3 months or less.

For details on section 444 elections, see Publication 538.

**Making the election.** Unless you are a corporation electing S corporation status, make the section 444 election by filing **Form 8716** with the Internal Revenue Service Center where you normally file your returns. Form 8716 must be filed by the earlier of:

- 1) The 15th day of the 6th month of the tax year for which the election will first be effective, or
- 2) The due date, without extensions, of the income tax return resulting from the section 444 election.

In addition, you must attach a copy of Form 8716 to your Form 1120S for the first tax year for which the election is made.

**Required payment for S corporations.** S corporations generally must make a required payment for any tax year that:

- 1) The section 444 election is in effect, and
- 2) The required payment amount is more than \$500 for the tax year or any previous tax year.

**Form 8752.** Form 8752 is used to figure the required payment or refund.

For more information on the required payment, see the instructions for Form 8752.

**Ending the election.** The section 444 election remains in effect until it is terminated. The election ends when the S corporation:

- 1) Changes to its required tax year,
- 2) Liquidates,
- 3) Willfully fails to comply with the required payments or distributions, or
- 4) Becomes a member of a tiered structure (unless the tiered structure consists entirely of S corporations with the same tax year).

The election will also end if an S corporation’s S election is terminated. If an S corporation terminates its S election and immediately becomes a personal service corporation, the personal service corporation can continue the section 444 election of the S corporation.

If an S corporation with a tax year other than the required tax year decides to terminate its section 444 election, the entity must file a “short-period” return for the required tax year by its due date (including extensions) to effect a valid termination. When filing the short-period return or extension request, type or print legibly at the top of the first page of Form 1120S or the extension request, **SECTION 444 ELECTION TERMINATED**.

If the election is terminated, another section 444 election cannot be made for any tax year.

## S Corporation Income and Expenses

Shareholders must report their pro rata shares of an S corporation’s income, losses, deductions, and credits on their returns. See *Figuring*

*Shareholder Taxable Income*, later. To figure these amounts, the S corporation must divide these items into two categories — separately stated items and nonseparately stated items.

Other rules, such as elections an S corporation can make, treatment of carryovers and carrybacks, and transactions with related parties, affect how the corporation figures its income and expenses. These are discussed later under *Other Items That Affect S Corporation Income and Expenses*.

## Separately and Nonseparately Stated Items

All S corporation items of income, loss, deduction, or credit are passed through to the shareholders and reported on their individual returns. If the separate treatment of any item could affect a shareholder's tax liability, that item must be passed through separately. These items are referred to as separately stated items. They are entered on lines 2 through 23 of Schedules K and K-1.

All other items are combined and referred to as nonseparately stated income or loss. This is the ordinary income or loss shown on line 21 of Form 1120S and line 1 of Schedule K and K-1.

Both the separately stated items and the nonseparately stated income or loss are **passed through** to the shareholders by the S corporation in proportion to their shareholdings. See *Figuring Shareholder Taxable Income*, later. Before they are passed through to the shareholders, some items may be reduced, as explained later under *Reducing passthroughs*.

The list of items that must be separately stated includes, but is not limited to:

- 1) Net income or loss from rental real estate activities,
- 2) Net income or loss from other rental activities,
- 3) Portfolio income or loss—
  - Interest income,
  - Dividend income,
  - Royalty income,
  - Short-term capital gain or loss, and
  - Long-term capital gain or loss,
- 4) Section 1231 net gain or loss,
- 5) Charitable contributions,
- 6) Section 179 expense deduction,
- 7) Expenses related to portfolio income or loss,
- 8) Credits—
  - Low-income housing credit,
  - Qualified rehabilitation expenses, and
  - Other credits,
- 9) Investment interest expense, and
- 10) Tax preference and adjustment items needed to figure shareholders' alternative minimum tax.

**Note.** The indirect deduction through an S corporation of amounts that are not allowable as a deduction if paid or incurred directly by an individual is not allowed. For example, an individual cannot avoid the 2% floor on miscellaneous itemized deductions by allowing an S corporation in which he or she is a shareholder to pay and deduct these amounts.

**Nonbusiness bad debt.** An S corporation that has a nonbusiness bad debt must separately state the debt as a short-term capital loss in the year it becomes wholly worthless.

**Noncash charitable contributions.** For all noncash contributions totaling more than \$500, the S corporation must complete and attach Form 8283, *Noncash Charitable Contributions*, to its return. In addition, if the value of a contributed item or group of similar items is more than \$5,000, the corporation must give a copy of its Form 8283 to each shareholder, even though the amount allocated to each shareholder is \$5,000 or less.

**Interest expense allocated to debt-financed distributions.** If an S corporation distributed borrowed funds to a shareholder, the corporation should separately state the interest expense on these funds and list as "Interest expense allocated to debt-financed distributions" under other deductions on the shareholder's Schedule K-1, discussed later. Whether the shareholder can deduct this interest on his or her tax return depends on how the shareholder uses the funds. See *Partnerships and S Corporations* in chapter 8 of Publication 535.

**Investment interest.** If the S corporation borrows money to buy or carry investment property, interest expense from these debts must be identified and separately stated on Schedule K-1 (Form 1120S) for each shareholder. This interest expense does not include any amounts used in determining income or loss from a passive activity.

Investment income and investment expenses other than interest must also be separately stated on Schedule K-1 (Form 1120S). See Publication 550 for more information.

**Tax preference items.** If an S corporation (or any predecessor) was a regular corporation for any of the 3 immediately preceding tax years, the S corporation must adjust its tax preference items. In determining its taxable income, these items, which are also items subject to alternative minimum tax and are considered tax preference items, must be adjusted as follows:

- 1) **Section 1250 capital gain treatment.** For section 1250 property disposed of during the tax year, 20% of the amount that would be ordinary income if the property were section 1245 property, minus the amount treated as ordinary income under section 1250, is treated as gain that is ordinary income under section 1250. **Section 1250 property** includes all real property that is subject to an allowance for depreciation and that is not or has

never been section 1245 property. **Section 1245 property** includes any property that is or has been subject to an allowance for depreciation and that is personal property (both tangible and intangible), and certain other property. See Publication 544 for more information on these kinds of property.

- 2) **Percentage depletion.** For iron ore and coal (including lignite), the amount allowable as a percentage depletion deduction is reduced by 20% of the amount of the percentage depletion deduction allowable for the tax year (determined without this adjustment) minus the adjusted basis of the depletable property at the close of the tax year (figured without the depletion deduction for the tax year).
- 3) **Pollution control facilities.** The amortizable basis of pollution control facilities is reduced by 20% for purposes of determining the amortization deduction for that property.
- 4) **Mineral exploration and development costs.** The amount allowable as a deduction for mineral exploration and development costs is reduced by 30%. Special rules apply to the amount not allowed because of this adjustment. This reduction also applies to the intangible drilling costs of an integrated oil company.

These adjustments do not apply to an S corporation unless it (or any predecessor) was a regular corporation for any of the 3 immediately preceding tax years.

If an adjustment is made to a tax preference item under the above rules, the adjusted amount is shown on Schedule K-1 as a tax preference item for the shareholder.

**Reducing passthroughs.** If an S corporation is subject to the capital gains tax, the tax on built-in gains, or the tax on excess net passive income, discussed later under *S Corporation Taxes*, the related items are reduced in the following ways:

- 1) The amount of the corporation's long-term capital gain is reduced by any capital gains tax the corporation has to pay. If the amount of that tax is more than the long-term capital gains, the excess is used to reduce the gain on the sale or exchange of section 1231 property. For this purpose, "long-term capital gain" does not include any gain from the sale or exchange of any section 1231 property.
- 2) The amount of each recognized built-in gain is reduced by its proportionate share of the tax the corporation has to pay on these gains.
- 3) The amount of each item of passive investment income is reduced by a portion of the tax on excess net passive income the corporation has to pay. Each item is reduced by an amount that has the same ratio to the tax on excess net passive income as each item of passive investment income has to the total passive investment income for the tax year.

**Limits for certain items.** The limits for the following items are applied to both the S corporation and to the S corporation shareholder:

- 1) The \$17,500 limit on the section 179 deduction. See Publication 946 for more information.
- 2) The \$10,000 limit on reforestation costs. See chapter 12 in Publication 535 for more information.

**Distribution of appreciated property.** An S corporation that distributes appreciated property to a shareholder will be treated as if it had sold the property for fair market value. It will have to recognize any gain and pass that gain through to its shareholders.

## Other Items That Affect S Corporation Income and Expenses

The following items also affect how an S corporation figures its income and expenses.

**Choosing income tax treatment of an item.** The S corporation makes all the elections that affect the computation of items it has to report on its return, except as noted below.

Each shareholder, rather than the S corporation, makes the following elections:

- 1) The elections on deduction and recapture of certain mining exploration costs. See Publication 535 for more information.
- 2) The election on whether to deduct or claim a foreign tax credit for taxes the S corporation pays or accrues to foreign countries or U.S. possessions. See Publication 514, *Foreign Tax Credit for Individuals*.

**Carryovers and carrybacks.** An S corporation cannot carry over or carry back any item from a year that the corporation is not an S corporation to a year that the corporation is an S corporation.

However, each year the corporation is an S corporation counts as a year for the purpose of determining the number of years to which an item can be carried back or carried over.

**Example.** In its first tax year, a corporation had a net operating loss. In its second year, it became an S corporation. It generally cannot use the net operating loss carryover in this second tax year or in any tax year during which it is an S corporation.

Each year that the corporation is an S corporation counts as a year for purposes of figuring the 15-year carryforward period for net operating losses. If the S corporation does not terminate its status before the end of the 15-year net operating loss carryforward period, the net operating loss incurred in that first tax year, when it was not an S corporation, cannot be used.

**Disallowed losses.** Losses realized on sales or exchanges of property between related parties generally cannot be deducted. If the related party who acquired the property on which the loss was disallowed later resells the

property at a gain, the gain is recognized only up to the amount that is more than the disallowed loss.

**Related parties.** For purposes of the rule on disallowed losses, related parties include the following:

- 1) Two corporations that are members of the same controlled group of corporations determined by applying a 50% ownership test,
- 2) An individual and a corporation if more than 50% of the value of the outstanding stock is owned by the individual,
- 3) A trust fiduciary and a corporation if the trust or grantor of the trust owns more than 50% in value of the outstanding stock of the corporation,
- 4) The grantor and a fiduciary of any trust,
- 5) A fiduciary of a trust and a beneficiary of the trust,
- 6) Any two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation,
- 7) An S corporation and a corporation that is not an S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation, and
- 8) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or profits interest, in the partnership.

**Ownership of stock.** In deciding whether a person owns any of the outstanding stock of a corporation, the following rules apply:

- 1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries,
- 2) An individual is treated as owning the stock owned, directly or indirectly, by or for his or her family,
- 3) Any individual owning, other than by applying paragraph (2), any stock in a corporation is treated as owning the stock owned, directly or indirectly, by or for his or her partner,
- 4) The family of an individual includes only his or her brothers and sisters (half-brothers or half-sisters), spouse, ancestors, and lineal descendants, and
- 5) Stock constructively owned by a person under paragraph (1), for applying paragraphs (1), (2), or (3), is treated as actually owned by that person. But stock constructively owned by an individual under paragraphs (2) or (3) is not treated as owned by him or her, for again applying either paragraph (2) or (3), to make another person the constructive owner of that stock.

### Unpaid business expenses and interest.

An accrual method S corporation must use the cash method to deduct business expenses

and interest owed to cash method related parties. An S corporation cannot deduct business expenses or interest owed to a cash basis related party until the day payment is made and the amount is includable in the related party's gross income. This rule will apply even if the S corporation and the related person cease to be related before the expenses or interest are includable in that person's gross income.

**Related parties.** Related parties include those just listed under *Disallowed losses*. Related parties also include, in the case of any amount paid or incurred by, to, or on behalf of an S corporation:

- 1) An S corporation and any person who owns, directly or indirectly, any of the stock of the S corporation,
- 2) An S corporation and any person who owns, directly or indirectly, any capital or profits interest of a partnership in which this S corporation owns, directly or indirectly, any capital or profits interest, and
- 3) Any person related under the related party rules to a person described in (1) or (2).

The rule in (2) applies to a transaction only if the transaction is related either to the operations of the partnership or to an interest in this partnership.

**The S corporation as a shareholder.** If an S corporation is a shareholder in another corporation, it is treated as an individual for purposes of corporate distributions and adjustments. For example, if an S corporation receives a distribution of property based on the stock it holds, the tax effect of the distribution is figured as if the S corporation is an individual and not a corporation.

**Corporate organizational expenses.** An S corporation can choose to amortize corporate organizational costs over a period of not less than 60 months. See chapter 12 in Publication 535 for more information.

**Uniform capitalization rules.** Certain costs incurred in connection with property produced or acquired for resale must be capitalized or included in inventory. These rules do not apply to personal property acquired for resale unless the corporation's average annual gross receipts for the 3 preceding tax years are more than \$10 million. See section 1.263A of the Income Tax Regulations for more information on uniform capitalization rules.

### Income from discharge of indebtedness.

Generally, S corporations must include in income amounts realized from the discharge of indebtedness. The debt is not included as income if the cancellation:

- 1) Takes place in a title 11 bankruptcy case,
- 2) Takes place when the corporation is insolvent and the amount excluded is not more than the amount by which the corporation is insolvent,
- 3) Is a discharge of qualified farm indebtedness, or

- 4) Is a discharge of qualified real property business indebtedness.

However, such items as net operating losses, general business credit carryovers, capital loss carryovers, basis in property, and foreign tax credit carryovers are reduced by the amount of the discharged debt.

For more information on bankruptcy and other debt cancellation, see Publication 908. For more information on exclusion of income from cancellation of deductible debt, see chapter 6 in Publication 334.

## S Corporation Taxes

The S corporation, like any other business, pays its own excise and employment taxes. See Publication 510, *Excise Taxes for 1996*, and Publication 15, *Circular E, Employer's Tax Guide*. It is subject to income tax only in certain instances.

An S corporation may be subject to the following taxes:

- 1) The tax on excess net passive investment income,
- 2) The tax on certain capital gains,
- 3) The tax on built-in gains,
- 4) The tax from recomputing a prior-year investment credit, or
- 5) LIFO recapture tax.

If the corporation was incorporated and elected S corporation status before 1987, it generally need not be concerned with the tax on built-in gains.

**Estimated tax payments.** If an S corporation's tax liability for certain capital gains, net recognized built-in gain, excess net passive income, and recapture of investment credit totals \$500 or more, the S corporation must pay quarterly estimated tax payments.

Generally, the quarterly estimated tax payments must equal 25% of the required annual estimated tax. The amount of estimated tax that must be paid annually is the lesser of:

- 1) 100% of the tax shown on the return for the tax year (or, if no return is filed, 100% of the tax for that year), or
- 2) The sum of —
  - a) 100% of the investment credit recapture and the tax on net recognized built-in gain, (or the tax on certain capital gains) shown on the tax return for the tax year (or if no return is filed, 100% of these taxes for the year), and
  - b) 100% of any tax on excess net passive income shown on the corporation's return for the preceding tax year.

If the preceding tax year was less than 12 months, the amount of the required annual estimated tax must be determined under (1), above. For more information, see the discussion on annualizing under *Estimated Tax* in Publication 542.

**Time and amount of deposits.** If a corporation's estimated tax is \$500 or more, its estimated tax payments must be deposited with an authorized financial institution or a Federal Reserve Bank. Each deposit must be accompanied by a federal tax deposit coupon and deposited according to the instructions in the coupon book (Form 8109).

The due date of deposits is determined according to the table below. An S corporation's estimated tax should be deposited by the 15th day of the following months of the corporation's tax year.

Required Payment	Month Due
1st .....	4th month
2nd .....	6th month
3rd .....	9th month
4th .....	12th month

A corporation that does not make a payment when it is due may be charged a penalty for the period of underpayment.

## Tax on Excess Net Passive Income

If an S corporation has pre-S corporation earnings and profits at the end of a tax year and its passive investment income, defined later, is more than 25% of its gross receipts, the S corporation may be subject to a tax on excess net passive income.

An S corporation will not be subject to the tax on excess net passive income if it has been an S corporation for each of its tax years.

**Gross receipts.** The term "gross receipts" means the total amount an S corporation receives or accrues under the method of accounting it uses to figure its taxable income. Gross receipts are not reduced by returns and allowances, cost of goods sold, or deductions. Gross receipts include the total amount received or accrued from the sale or exchange of any kind of property (except capital assets and stock or securities), from services rendered, or from investments. Only the capital gain net income from the sale or exchange of capital assets (other than stock or securities) and only the gains from the sale or exchange of stock or securities are included in gross receipts.

Gross receipts do not include amounts received from:

- 1) A loan,
- 2) Repayment of a loan,
- 3) Contributions to capital,
- 4) Issuing stock in the S corporation,
- 5) A nontaxable sale or exchange, except to the extent that gain is recognized by the S corporation, or
- 6) The deferred or unrecognized portion of any gain on sales or exchanges made from an installment sale, except for installment sales of publicly traded stocks and securities.

**Sales or exchanges of stock or securities.** A sale or exchange of stock or securities is included in gross receipts only to the extent

of the gain. Losses on sales or exchanges are not a part of gross receipts. Nor are they offset against gains on sales or exchanges when figuring gross receipts.

However, amounts received in exchange for stock in a corporate liquidation are not included in gross receipts if the S corporation owned more than 50% of each class of the liquidating corporation's stock on the date of the first distribution with respect to the liquidation. This 50% requirement applies to a class of stock whether or not the class of stock has voting rights. For this requirement, shares of stock of the liquidating corporation held by an S corporation shareholder are not treated as held by the S corporation.

**Passive investment income.** Passive investment income includes gross receipts from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. The amount included in passive investment income for sales or exchanges of stock or securities for an S corporation that is not an "options dealer" or "commodities dealer" is figured, as explained above, under *Sales or exchanges of stock or securities*.

If the S corporation is an "options dealer" or a "commodities dealer," any gains or losses from section 1256 contracts (regulated futures contracts, foreign currency contracts, nonequity options, and dealer equity options) or from property related to such contracts are not included when the computations are made.

**Royalties.** Royalties generally mean all royalties, including mineral, oil, and gas royalties, and amounts the S corporation receives for the use of patents, copyrights, secret processes, formulas, goodwill, trademarks, trade brands, franchises, and other like property. The gross amount of royalties is not reduced by any part of the cost of the rights under which the royalties are received or by any amount allowable as a deduction in computing taxable income.

Royalties do not include amounts from the ordinary course of a trade or business of franchising or licensing property. Royalties received by a corporation are considered to be from the ordinary course of a trade or business of franchising or licensing property only if, based on all available information, the corporation:

- 1) Created the property, or
- 2) Provided significant services or incurred substantial costs in the development or marketing of the property.

Royalties do not include:

- 1) Copyright royalties, mineral royalties, oil royalties, and gas royalties if the income from those royalties would not be treated as personal holding company income and if the corporation was a regular corporation. See IRS code section 543(a)(3) and (4) for information on what is personal service income.
- 2) Amounts received upon disposal of timber, coal, or domestic iron ore to which special rules apply if the seller retains an



economic interest, and (See IRS code section 631(b) and (c))

- 3) Active business computer software royalties received by any corporation during the tax year in connection with the licensing of computer software subject to certain requirements. See IRS code section 543(d).

**Rents.** Rents are amounts the S corporation receives for the use of, or the right to use, its real or personal property.

Rents do not include amounts from the active trade or business of renting property. The rental is an active trade or business if the S corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are **not** provided and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is based on facts and circumstances including, but not limited to, the number of persons employed to provide the services and the kinds and amounts of expenses incurred (other than depreciation).

Rents do not include produced film rents. Produced film rents are payments received for an interest in a film for the use of, or the right to use, the film, but only to the extent that the interest was acquired before the film was substantially completed.

Rents do not include compensation for the use of, or right to use, any real or tangible personal property developed, manufactured, or produced by the S corporation if during the tax year the corporation substantially develops, manufactures, or produces real or tangible personal property of the same type.

**Interest.** Interest is any amount received for the use of money, including tax-exempt interest and unstated interest. Unstated interest includes amounts considered interest on notes or obligations received in installment sales, obligations issued for property, and below-market loans when the contract does not contain a stated rate of interest, or the stated rate is below the appropriate federal rate. See Publication 537, *Installment Sales*, and *Below-market interest rate loans*, later.

However, interest on obligations acquired in the ordinary course of the S corporation's trade or business from the performance of services or the sale of inventory or property held primarily for sale to customers is excluded from passive investment income.

**Figuring the tax on excess net passive income.** An S corporation is liable for tax on excess net passive income if its passive investment income is more than 25% of gross receipts and if at the end of the tax year it has earnings and profits from any tax year in which the corporation was not an S corporation. The tax is imposed at the highest corporate rate (currently 35%).

**Net passive income.** Net passive income is passive investment income, described earlier reduced by deductions directly connected with the production of passive investment income. This does not include net operating

losses and dividends-received deductions allowed to corporations that are not S corporations.

Investment-related deductions allowable in figuring net passive income generally include brokerage fees, interest expenses, safe deposit box rentals, and investment advisory fees.

**Excess net passive income.** Excess net passive income for the tax year is the amount that has the same ratio to net passive income as the amount of passive investment income that is more than 25% of gross receipts has to total passive investment income. To figure excess net passive income, multiply net passive income by a fraction consisting of passive investment income minus 25% of gross receipts over passive investment income.

Excess net passive income cannot be more than the S corporation's taxable income for the year (with certain adjustments). See *Figuring corporate taxable income*, later.

A worksheet is provided in the instructions for Form 1120S to figure the tax on excess net passive income.

**Special rules.** The only credit that can be used by the S corporation to offset this tax is the credit figured on Form 4136, *Credit for Federal Tax Paid on Fuels*.

If any gain is used to figure both the tax on excess net passive income and the tax on capital gains, the amount of gain subject to the capital gains tax is reduced, as explained later under *Reducing corporate capital gains*. The amount of passive investment income for purposes of figuring the tax on excess net passive income is determined by not taking into account any recognized built-in gain or loss of the corporation.

If the S corporation is subject to the tax on excess net passive income, it must reduce the items of passive income passed through to the shareholders, as described earlier under *Reducing passthroughs*.

**Waiver of tax on excess net passive income.** The IRS may waive the tax on excess net passive income if the S corporation establishes to IRS's satisfaction that:

- 1) It determined in good faith that it had no pre-S corporation earnings and profits at the close of the tax year, and
- 2) During a reasonable period of time after it was determined that it did have such earnings and profits at the close of the tax year, the earnings and profits were distributed.

## Tax on Capital Gains

An S corporation that elected S corporation status before 1987 may be liable for a capital gains tax if:

- 1) Its net long-term capital gain minus its net short-term capital loss is more than \$25,000,
- 2) The excess is more than 50% of the corporation's taxable income, and
- 3) The taxable income is more than \$25,000.

If the S corporation is also liable for the tax on excess net passive income, it should figure that tax before it figures its capital gains tax.

Before an S corporation can decide whether it is liable for the capital gains tax, it must:

- 1) Reduce its capital gains to the extent they are subject to the tax on excess net passive income, and
- 2) Figure its taxable income.

**Reducing corporate capital gains.** If the S corporation is subject to the tax on excess net passive income, it must reduce its capital gains by the share of excess net passive income that is due to the capital gains. This reduced capital gain is the amount used to decide whether the corporation must pay a capital gains tax and how much is due.

**Figuring corporate taxable income.** Although an S corporation's taxable income is generally figured like a partnership's for filing a return, taxable income for the tax on capital gains, the tax on built-in gains, discussed later, and the limit on excess net passive income are figured, with certain modifications, as though the corporation is filing a corporate tax return.

Taxable income is the gross income of the corporation minus most deductions, including the amortization deduction for corporate organization costs allowed to a corporation. But it does not include the net operating loss deduction or other special deductions for corporations, such as the dividends-received deductions.

The easiest way to make this calculation is to use page 1 of Form 1120, lines 1 through 28. The amount on line 28 is the amount of taxable income.

**Applying the capital gains tax.** When the S corporation knows the amount of its capital gains (reduced if necessary, as explained above) and its taxable income, it can answer "yes" or "no" to the following questions and use its answers to decide if it is liable for the capital gains tax. The questions refer to the Form 1120S Schedule D

- A. Is net capital gain (line 15, Schedule D) more than \$25,000, and more than 50% of taxable income (see the instructions for line 19, Schedule D)? .....  Yes  No
- B. Is taxable income (see the instructions for line 19, Schedule D) more than \$25,000? .....  Yes  No
- C. Does any long-term capital gain (line 14, Schedule D) represent gain from substituted basis property (defined next) .....  Yes  No

**Caution.** As this publication was being prepared for print, Congress was considering legislation that would affect capital gains and losses. The line numbers on Schedule D (Form 1120S) could change for 1995. See

Publication 553, *Highlights of 1995 Tax Changes*, for further developments. Information on these changes will also be available electronically through our bulletin board or via the Internet (see page 34 of the Form 1040 Instructions).

For purposes of the capital gains tax, **substituted basis property** is property that:

- 1) Was acquired by the S corporation during the period that began 36 months before the first day of the tax year and ended on the last day of the tax year, and
- 2) Has a basis determined by reference to the basis of any property in the hands of another corporation, if the other corporation was **not** an S corporation throughout the period that began the later of:
  - a) 36 months before the first day of the tax year, or
  - b) The time the other corporation came into existence,

and ended on the date the other corporation transferred the property used to determine the basis of the property acquired by the S corporation.

If the S corporation answers "yes" to A, B, and C, the tax applies and Schedule D (Form 1120S) must be completed.

**Amount of tax.** If the capital gains tax applies, the amount of the tax is the lesser of:

- 1) 35% of the amount by which the net long-term capital gain minus the net short-term capital loss is more than \$25,000, or
- 2) The tax that would have been charged on the corporation's taxable income if it were not an S corporation.

**Limit for property with a substituted basis.** If the capital gains tax applies only because the property has a substituted basis (Question C was answered "yes"), the tax cannot be more than 35% of the net capital gain (net long-term capital gain minus net short-term capital loss) that is due to the property with the substituted basis.

**Special rules.** The only credit that can be used to offset this tax is the credit for federal tax on fuels. The corporation's long-term capital gains for the tax year must be reduced, as explained earlier under *Reducing passthroughs*.

## Tax on Built-In Gains

If an S corporation has a net recognized built-in gain for any tax year beginning in the recognition period, a tax is imposed on the income of the S corporation for that tax year. The **recognition period** is the 10-year period beginning with the first day of the first tax year the corporation was an S corporation.

The first tax year a corporation is treated as an S corporation is determined by its most recent election to be an S corporation.

The tax generally applies only to a corporation that converted from a C corporation to an S corporation after 1986. It does not apply to

any corporation if an election to be an S corporation was in effect for each of its tax years.

**Amount of tax.** The amount of tax is figured by applying the highest corporate rate of tax to the net recognized built-in gain of the S corporation for the tax year. The highest corporate rate of tax is currently 35%.

**Net recognized built-in gain.** Generally, the term "net recognized built-in gain" for any tax year in the recognition period is **the least of:**

- 1) The amount that would be taxable income of an S corporation for the tax year if only recognized built-in gains, recognized built-in losses, and recognized built-in gain carryover, (pre-limitation amount) were taken into account, or
- 2) The amount that would be taxable income of the corporation if it were not an S corporation (taxable income limitation). Taxable income is generally the gross income of the corporation minus most deductions, including the amortization deduction for corporate organization costs allowed a corporation. But it does not include the net operating loss deduction or other special deductions for corporations, such as the dividend-received deductions, or
- 3) The amount by which its net unrealized built-in gain is more than its net recognized built-in gain for all prior tax years in the recognition period (net unrealized built-in gain limitation).

If an S corporation's taxable income limitation or net unrealized built-in gain limitation for any tax year is less than its pre-limitation amount so that, its net recognized built-in gain for that year is less than its pre-limitation amount, the S corporation's net recognized built-in gain consists of a ratable portion of each item of income, gain, loss, and deduction included in the pre-limitation amount.

**Carryover.** If the taxable income limitation applies to limit net recognized built-in gain in a tax year, the pre-limitation amount minus the taxable income limitation is treated as recognized built-in gain in the following tax year. The carryover provision does not apply to corporations that elected to be S corporations before March 31, 1988.

**Recognized built-in gains.** The term "recognized built-in gain" is any gain recognized during the recognition period when any asset is disposed of in a sale or exchange, except to the extent the S corporation shows that:

- 1) The asset was **not** held by the S corporation at the beginning of its first tax year as an S corporation, or
- 2) The gain is more than:
  - a) The assets fair market value at the beginning of the first year as a S corporation, minus
  - b) The adjusted basis of the asset at the beginning of that year.

**Income items.** With limited exceptions, a recognized built-in gain also includes any item of income properly taken into account during the recognition period, to the extent an accrual method taxpayer would have properly included the item in gross income before the recognition period.

For example, the collection of accounts receivable by a cash method S corporation is recognized built-in gain.

**Recognized built-in loss.** A recognized built-in loss is any loss recognized during the recognition period when any asset is disposed of in a sale or exchange, to the extent the S corporation shows that:

- 1) The asset was held by the S corporation at the beginning of its first year as an S corporation, and
- 2) The loss is not more than:
  - a) The adjusted basis of the asset at the beginning of its first tax year as an S corporation, minus
  - b) The fair market value of the asset at the beginning of that year.

**Deduction items.** With limited exceptions, any amount properly taken as a deduction during the recognition period (determined without regard to any carryover), that would have been allowed as a deduction by an accrual method taxpayer before the recognition period, is treated as a recognized built-in loss for the tax year it is allowable as a deduction.

**Net unrealized built-in gains.** Generally, net unrealized built-in gain is:

- 1) The fair market value of the assets of an S corporation at the beginning of its first tax year when an election to be an S corporation is in effect, minus
- 2) The total adjusted basis of these assets at that time.

**Adjustment to net unrealized built-in gain.** The net unrealized built-in gain must be adjusted for items of income or deduction treated as recognized built-in gains or losses.

**Credits.** The only credits allowed against the tax on built-in gains are the gasoline and special fuels tax credit and any carryforward of the general business credit or minimum tax credit from a pre-S corporation year.

**Net operating and capital loss carryovers from pre S corporation tax year.** Any net operating loss carryover from a pre-S corporation tax year is allowed as a deduction against the net recognized built-in gain of the S corporation for the tax year. To determine the loss that can be carried to later years, the net recognized built-in gain is treated as taxable income. The same rules apply for a capital loss carryover from a pre-S corporation tax year.

**Treatment of certain property.** If the adjusted basis of any asset is fully or partly determined by the adjusted basis of another asset

held by the S corporation at the beginning of its first tax year as an S corporation:

- 1) The asset is treated as held by the S corporation at the beginning of that first tax year, and
- 2) Recognized built-in gain or loss is determined by the difference between fair market value and adjusted basis of the asset at the beginning of that first tax year.

**Transfer of assets from a corporation to an S corporation.** Generally, if an S corporation acquires an asset, and its basis in the asset is fully or partly determined by a C corporation's basis in the asset, then a tax on built-in gains is imposed on any net recognized built-in gain from the asset for any tax year beginning in the recognition period.

However, when figuring the tax, the day the assets were acquired by the S corporation must be taken into account rather than the beginning of the first tax year the corporation was an S corporation. This tax applies even if the S corporation was always an S corporation.

**Partnership Interests.** If an S corporation owns an interest in a partnership, the built-in gains tax also applies to the S corporation's distributive share of the partnership's income, gain, loss, or deductions, as if the partnership items had originated in and been taken into account directly by the S corporation.

**Certain transfers to partnerships.** If a corporation transfers an asset to a partnership:

- 1) In exchange for an interest in the partnership; and
- 2) No gain or loss is recognized by either the partnership or any of its partners, and
- 3) The transfer is made either in contemplation of an S election or during the recognition period,

the built-in gains tax will apply on a disposition of the asset by the partnership as if the S corporation had disposed of the asset.

**Certain inventory dispositions.** When figuring net recognized built-in gain, the inventory method you use for tax purposes must be used to identify whether goods disposed of following conversion to S corporation status were held by the corporation at the time of conversion.

**Certain contributions of built-in loss assets.** Assets acquired with a principal purpose of avoiding the built-in gains tax are disregarded in determining the S corporation's built-in gains tax.

**Certain installment sales.** This rule applies for installment sales occurring after March 25, 1990.

If you sell an asset either before or during the recognition period and, using the installment method, you recognize income from the sale either during or after the recognition period, any income you recognize will be subject to the tax on built-in gains. The tax is limited to

the aggregate amount by which net recognized built-in gain for all tax years in the recognition period would have been increased if all gain from the sale were reported in the year of the sale (or in the first year of the recognition period if the sale was before the recognition period). If this limitation applies in a tax year, the excess of the amount reported under the installment method over the amount subject to tax under the limitation is subject to tax in the succeeding tax year if that year is in the recognition period.

**Additional rules.** Depending upon the effective date of an S corporation's election, other rules may apply with respect to partnership interests held by an S corporation; installment sales; inventory dispositions; and contributions of built-in loss assets to an S corporation.

For more information about tax on built-in gains see section 1.1374 of the Income Tax Regulations. You can read the full text of these regulations at many public libraries.

## Tax from Recomputing a Prior-Year Investment Credit

This tax may apply if the corporation claimed investment credit on a prior year's corporate income tax return before it became an S corporation. If the S corporation makes an early disposition of the property, the S corporation, and not its shareholders, will be liable for payment of the tax. The corporation must complete Form 4255, *Recapture of Investment Credit*, and include the tax in the total amount to be entered on line 22(c), page 1 of Form 1120S. Write the words "Tax from Form 4255" on this line.

## LIFO Recapture Tax

If a corporation made an election to be an S corporation after December 17, 1987, and used the LIFO inventory pricing method for its last tax year before its S election became effective, the corporation may be liable for LIFO recapture.

The corporation's LIFO recapture amount is equal to the inventory amount using the FIFO method minus the inventory amount using the LIFO method at the close of the corporation's last tax year before becoming an S corporation.

The LIFO recapture tax is figured for the pre-S corporation's last tax year. (See the instructions for Form 1120 or Form 1120A.) The LIFO tax is paid in four equal installments. The first installment is due with the corporation's Form 1120 or Form 1120A for the corporation's last tax year, and the three remaining deferral installments are paid with the corporation's Form 1120S for the next 3 tax years. Include each year's installment in the total amount to be entered on line 22c, page 1 of Form 1120S. Write to the left of line 22c the total installment amount and the words "LIFO tax."

## Filing Form 1120S

A corporation must file Form 1120S if:

- 1) It elected to be taxed as an S corporation,
- 2) The IRS accepted the election, and
- 3) The election remains in effect.

**Due date of return.** If an S corporation's income tax return (Form 1120S) is made on a calendar year basis, the return must be filed by March 15 following the close of the tax year. If an S corporation is permitted to use a fiscal year as its tax year, its return must be filed by the 15th day of the 3rd month following the close of its fiscal year.

**Saturday, Sunday, or holiday.** If the last day (due date) for performing any act for tax purposes, such as filing a return or making a tax payment, falls on a Saturday, Sunday, or legal holiday, the corporation can act on the next day that is not a Saturday, Sunday, or legal holiday.

**Place for filing.** An S corporation files its Form 1120S with the Internal Revenue Service Center serving the area where the principal office for keeping the corporation's books and records is located. Service center locations are listed in the instructions to the forms.

**Payment of tax.** The corporation must pay any tax due in full by the 15th day of the 3rd month after the end of the tax year.

Corporation income tax payments and estimated tax payments must be deposited with a Federal Tax Deposit Coupon (Form 8109). The tax deposits should be made with either a financial institution qualified as a Depository for Federal Taxes or the Federal Reserve Bank or Branch serving the area where the corporation is located. Deposits should not be sent directly to an IRS office. Otherwise, the corporation may be subject to a penalty. Records of deposits will be sent to the IRS for crediting to the corporation's account. See the instructions contained in the coupon book (Form 8109) for more information.

For more information on deposits, see Publication 15.

**Late payment.** Payments of tax made after the due date are subject to an interest charge, even if filing extensions were granted. Payments of income tax made after the due date may also be subject to a penalty of 0.5% a month or part of a month up to a maximum of 25%.

**Extension of time for filing.** An S corporation will receive an automatic 6-month extension to file a return by submitting an application for extension on Form 7004, *Application for Automatic Extension of Time To File Corporation Income Tax Return*. This form is filed with the Internal Revenue Service Center where the S corporation must file its income tax return. The IRS can terminate this extension at any time by mailing a termination notice to the corporation. Form 7004 must be filed by the due date of the S corporation's income tax return.

Any automatic extension of time for filing an S corporation's income tax return will not extend the time for payment of any tax due as shown on the return.

**Late filing.** If an S corporation does not file its return by the due date, including extensions, and if it cannot show reasonable cause, a delinquency penalty of 5% of the tax due will apply if the delinquency is for not more than one month. An additional 5% is imposed for each additional month or part of a month during which the delinquency continues. The penalty is limited to a total of 25%. The tax due is the tax liability that would be shown on a return minus credits and any tax payments made before the due date. The penalty for late filing is reduced by the late payment penalty.

If the return is not filed within 60 days after the due date, including extensions, the penalty for late filing will be at least \$100 or the balance of tax due, whichever is less. This will not apply if reasonable cause is shown.

**Reasonable cause.** An S corporation that wishes to avoid a penalty for late filing or payment must be able to show reasonable cause. This should be done by filing with the Director of the Service Center where the return must be filed a statement of the facts establishing reasonable cause for failure to file a return or pay the tax on time. The statement must also contain a declaration that it has been made under the penalties of perjury.

**Schedule K-1 (Form 1120S).** An S corporation must furnish a copy of Schedule K-1, *Shareholder's Share of Income, Credits, Deductions, etc.*, or a substitute Schedule K-1, to each person or entity that was a shareholder during the year. Not furnishing this form or a substitute by the day Form 1120S was filed, not including all the required information, or including incorrect information may result in a \$50 penalty for each form either not furnished or furnished incomplete or incorrect. The total penalty, however, cannot be more than \$100,000 for the calendar year. For information on the substitute Schedule K-1, see the instructions for Schedule K and Schedule K-1 (Form 1120S).

**Criminal penalties.** Criminal penalties can be imposed for willful failure to file, tax evasion, or making a false statement.

**Amended return.** To correct an error on a Form 1120S already filed, the corporation should file a corrected Form 1120S and check box 4 in item F on the top part of the return. If the amended return results in a change to income, or a change in the distribution of any income or other information provided to shareholders, an amended Schedule K-1 (Form 1120S) must also be filed with the amended Form 1120S and given to each shareholder. Be sure to check box 2 in item D of each amended Schedule K-1.

## Figuring Shareholder Taxable Income

Each shareholder reports a pro rata share of each item of income, loss, deduction, or credit that is separately stated and a pro rata share of nonseparately stated income or loss on his or her income tax return.

When it is reported on the shareholder's income tax return, the character of any item included in a shareholder's pro rata share is determined as if the item were realized directly from the source from which the S corporation realized it, or incurred in the same manner in which the corporation incurred it.

Any time it is necessary to determine a shareholder's gross income, include the shareholder's pro rata share of the gross income of the corporation.

**Shareholder's treatment of S corporation items.** The tax treatment of any S corporation item is determined at the corporate level. Generally, a shareholder must treat S corporation items the same way on his or her tax return as they are treated on the S corporation return.

If an item on the shareholder's return is treated differently from the way it is treated on the S corporation return, the IRS can automatically assess taxes and penalties. It can take action to immediately collect any deficiency and penalties that result from an adjustment to the shareholder's individual return to make that treatment consistent with the amount or treatment of the item on the S corporation return. However, this adjustment does not apply if the shareholder files Form 8082, with his or her return identifying the different treatment.

The shareholder need not file Form 8082 if a loss, other deduction, or investment credit shown on Schedule K-1 (Form 1120S) is not reported in full on his or her return solely because the shareholder must limit the item, such as under the at-risk rules.

These rules do not apply to an S corporation with five or fewer shareholders if each shareholder is a natural person or an estate (but not a passthrough shareholder), unless the corporation chooses to have them apply. There cannot be more than five shareholders at any time during the year. For S corporations, a husband and wife, and their estates, are treated as one shareholder. For stock owned by tenants in common or joint tenants, each individual is considered a shareholder.

**Self-employment tax.** A shareholder's share of the corporation's taxable income is not self-employment income, even though it is included in gross income of the shareholder.

However, if a shareholder is an officer of the corporation and performs substantial services, he or she is considered an employee. Reasonable compensation for these services is subject to FICA, FUTA, and income tax withholding, no matter what the corporation calls the payments.

If an officer of the corporation who is responsible for the withholding of taxes willfully

fails to do so, he or she can be held liable for a penalty equal to the unpaid tax, plus interest. See *Trust fund recovery penalty* in Publication 15.

**Optional 10-year write-off of certain tax preferences.** Generally, shareholders who are individuals can elect to deduct ratably over 10 years the following qualified expenses incurred during the tax year:

- 1) Research and experimentation costs, and
- 2) Mining exploration and development costs.

Intangible drilling cost paid or incurred after 1989 can be deducted ratably over a 60-month period.

In addition, an S corporation shareholder can elect to deduct in equal installments over a 3-year period the cost of increasing the circulation of a newspaper, magazine, or periodical.

If one of these elections is made, the costs will not be considered a tax preference item and will not be used in figuring alternative minimum tax. The election is made at the shareholder level. These expenses are not deductible by the S corporation. Instead, they are passed through to S corporation shareholders on Schedules K and K-1 (Form 1120S), lines 16a and 16b. Shareholders who do not make the election for the expenses passed through may incur tax preference items reportable on Form 6251, *Alternative Minimum Tax—Individuals* or Schedule I (Form 1041), *Alternative Minimum Tax*.

These elections can be revoked only with the consent of the IRS. Each shareholder of an S corporation makes a separate election for his or her share of any qualified expense.

A shareholder can elect to use the optional write-off by the due date, including extensions, of the return for the year the election is made. The election is made by attaching a statement to the shareholder's return or filing Form 4562, *Depreciation and Amortization*, with the shareholder's return. For more information, see *Optional Write-off for Certain Expenditures* in the instructions for Form 6251.

**Pro rata share.** Except as explained later under *Terminating S Corporation Status*, each shareholder's pro rata share of each item to be entered on Schedules K and K-1 is figured on a per day, per share basis.

A pro rata share is figured as follows:

- 1) Divide the item by the number of days in the S corporation's tax year (to figure the daily amount of the item),
- 2) Multiply the daily amount of the item by the percentage of stock owned by the shareholder on that day (to figure the shareholder's daily part of the daily amount of the items), and
- 3) Total the shareholder's daily parts of the daily amount of the item (to figure the shareholder's pro rata share of the item for the tax year).

If there is no change in the percentage of stock a shareholder owns during the tax year, that shareholder's pro rata share of an item is the amount of the item times the percentage of stock owned by the shareholder during the year.

**Treatment of family groups.** If an individual who is a member of the family of one or more shareholders of an S corporation does not receive a reasonable compensation for services or capital furnished to the corporation, IRS can reallocate any items of income, deductions, etc., among the individual and shareholders who are members of the family to properly reflect the value of the services or capital. The family of any shareholder includes only the spouse, ancestors, lineal descendants, and trusts for the primary benefit of such persons.

**Below-market interest rate loans.** On certain loans an S corporation makes to employees or shareholders, the S corporation may be considered as having received interest income and having paid compensation or dividends equal to that interest. For more information, see chapter 8 in Publication 535.

**Health and accident insurance.** An S corporation can deduct health and accident insurance premiums paid on behalf of its shareholder-employees, their spouses, and dependents. Generally, the cost of these premiums is not included in the shareholder-employee's gross income. However, the cost is included in the gross income of a shareholder-employee who, on any day during the corporation's tax year, holds more than 2% of the corporation's outstanding stock or combined voting power.

For tax years beginning after 1994, a 2% shareholder-employee can deduct an amount equal to 30% of the part of these premiums paid for medical care if:

- 1) The amount deducted is not more than the earned income (wages) received as an employee of the S corporation, and
- 2) The shareholder-employee is not eligible to participate in any subsidized health plan maintained by any employer of the shareholder-employee or his or her spouse.

Shareholder-employees should see chapter 10 in Publication 535, *Business Expenses*, for more information on figuring the deduction.

**Medical deduction.** The 30% deduction for medical insurance premiums is taken on line 26, Form 1040. This amount should not be included with other medical expenses when figuring the medical deduction on Schedule A (Form 1040). However, the balance of the premiums may be included in medical expenses on Schedule A.

The deduction for medical insurance premiums is not to be taken into account in determining an individual's net earnings from self-employment.

These payments are not to be considered distributions for purposes of the one-class-of-stock requirement, discussed earlier.

**Reporting requirements.** An S corporation can deduct as **salary and wages** on Form 1120S the health and accident insurance premiums paid on behalf of its 2% shareholder-employees. If the payments are made under a plan or system for employees and their dependents, or for a class of employees and dependents, the payments generally are excluded from "wages" for social security and Medicare tax purposes.

The S corporation must file a Form W-2 for each of its 2% shareholder-employees and include these premiums as salary and wages for federal income tax purposes.

## Limits on Shareholder's Losses and Deductions

S corporation shareholders who hold stock at any time during the year claim their share of corporate losses and deductions, subject to certain limits, on their individual tax returns.

### Basis Limit

The amount of losses and deductions a shareholder can take is limited to the adjusted basis of:

- 1) The shareholder's stock, plus
- 2) Any loans the shareholder makes to the corporation.

To arrive at the adjusted basis of a shareholder's stock or loans, the shareholder's basis must first be determined. If the stock was purchased, the basis is usually its cost. If money was loaned to the S corporation, the basis is usually the amount of the loan. See Publication 551, *Basis of Assets*, for more information on basis. If a shareholder received stock in the S corporation in exchange for property, his or her basis in the stock is generally the same as his or her basis in the property transferred, with certain adjustments. See Publication 542.

A shareholder's guarantee of a third party loan to an S corporation does not increase the basis of the shareholder's stock, nor constitute a loan from the shareholder to the corporation. However, if a guarantor shareholder must make payments on the loan, the payments are treated as a loan from the shareholder to the S corporation.

For purposes of determining the limit, the adjusted basis of the shareholder's stock is figured at year end and includes the **increases**, but not the **decreases**, for that year listed later under *Adjustments to basis of shareholder's stock*. The adjusted basis of any loans is figured before any of the adjustments, discussed later under *Adjustments to basis of indebtedness*, are made for the tax year.

If the amount of the loss or deduction of a shareholder is limited, the excess is treated as incurred by the corporation in the next tax year for that shareholder. It can be carried over until used by that shareholder, unless it is limited by some other provision.

If the shareholder's losses or deductions are limited, as explained above, for the last tax

year the corporation is an S corporation, the excess is treated as incurred by the shareholder on the last day of the corporation's post-termination transition period. See *Post-termination transition period*, later. This excess amount cannot be more than the shareholder's adjusted basis of the stock in the corporation, determined at the close of the last day of the post-termination transition period. The losses or deductions taken into account during this period reduce the shareholder's basis in the stock of the corporation.

**Adjustments to basis of shareholder's stock.** During the time the corporation is an S corporation, each shareholder will increase or decrease the basis of his or her stock, but not below zero, as explained below.

**Increases.** Each shareholder's pro rata share of the following items increases the basis of the stock:

- 1) All income items of the S corporation, including tax-exempt income, that are separately stated,
- 2) Any nonseparately stated income of the S corporation, and
- 3) The amount of the deduction for depletion that is more than the basis of the property being depleted.

If an amount described in (1) or (2), above, must be included in income, a shareholder can increase the basis of the stock only by the amount actually included as gross income on his or her individual income tax return. This amount is increased or decreased by any adjustments in a redetermination of the shareholder's tax liability.

**Decreases.** Each shareholder's pro rata share of the following items decreases the basis of the stock:

- 1) Distributions by the S corporation that were not included in the shareholder's income because of the rules explained under *Distributions to Shareholders*, later,
- 2) All loss and deduction items of the S corporation that are separately stated,
- 3) Any nonseparately stated loss of the S corporation,
- 4) Any expense of the S corporation that is not deductible in figuring its taxable income and not properly chargeable to capital account, and
- 5) The shareholder's deduction for depletion of oil and gas property held by the S corporation to the extent it is not more than the shareholder's share of the adjusted basis of the property.

**Adjustments to basis of indebtedness.** In certain cases, a shareholder can decrease the basis of any loans he or she made to the S corporation, and in later years restore the basis.

**Reduction of basis.** If for any tax year the amounts specified in items (2), (3), (4), and (5), above, under *Decreases*, are more than the amount needed to reduce the shareholder's basis in stock to zero, the excess must be

used to reduce, but not below zero, the shareholder's basis in any loans made to the S corporation.

**Restoring basis of loans.** If the shareholder's basis in any loans made to the S corporation is reduced, as previously explained, any net increase for a later tax year, figured above under *Adjustments to basis of shareholder's stock*, should first be used to restore the basis of the loans and next to increase the basis of the stock.

**Loan repayments.** If the shareholder's basis in the loan was reduced (and has not subsequently been completely restored), he or she will have income (other than interest) when the S corporation makes a payment on the loan. Each loan payment (other than interest) must be allocated in part to a return of the shareholder's basis in the loan and in part to income.

To figure the amount of income to report from the loan payments, the shareholder should:

- 1) Figure the adjusted basis of the loan before payment.
- 2) Divide the adjusted basis in the loan by the outstanding loan balance.
- 3) Multiply the payment by the percentage from step (2). This amount is the part of the payment that will be a return of basis in the loan.
- 4) Take the difference between the amount of the payment and the amount from step (3). This is the amount that the shareholder must report as ordinary income.

The basis of the loan is reduced even if the shareholder has no tax benefit from the deduction for the basis reduction.

To figure the adjusted basis of the loan for a later payment, for a later restoration of basis, or for a later reduction of basis in the loan because of additional losses, the shareholder should subtract any amounts that are a return of basis from the adjusted basis of the loan.

**Worthless stock and debt.** If an S corporation's stock or loans to the S corporation become worthless during a tax year, the shareholder first adjusts the basis of his or her stock or debt by the shareholder's pro rata share of the corporation's items of income, deduction, etc., for that year.

After adjusting the basis of stock and loans, the shareholder must treat the worthless stock or registered loans as a loss from the sale or exchange of a capital asset. A worthless unregistered loan is treated as a short-term capital loss.

**Example.** If a shareholder has no basis in his or her S corporation stock, but has basis in debt owed by the corporation, and the debt becomes worthless, corporate losses for the year will first be passed through to the shareholder. These losses will reduce the shareholder's basis in the debt, which in turn will reduce the amount of the short-term capital loss for the worthless debt.

**Depletion of oil and gas property.** The cost or percentage depletion for oil and gas property is figured by each S corporation shareholder and not by the S corporation. The corporation gives to each shareholder a pro rata share of the basis of the oil or gas property at the later of:

- 1) The date the oil or gas property was acquired, or
- 2) The first day of the first tax year that begins after 1982 in which the corporation is an S corporation.

Shareholders must keep records of their share of the adjusted basis of each oil and gas property of the corporation, adjust their share of the adjusted basis for any depletion taken on the property, and use the adjusted basis each year to figure cost depletion or to figure gain or loss if the S corporation disposes of the property.

If the S corporation distributes the oil or gas property to its shareholders, the corporation's adjusted basis of the property is the sum of the shareholders' adjusted bases in the property.

### At-Risk Limit

At-risk rules may limit an S corporation shareholder's deductible loss from an activity conducted through an S corporation. These limitations apply at the shareholder level. An S corporation shareholder's amount at risk equals:

- 1) The shareholder's cash contributions and the adjusted basis of other property that the shareholder contributed to the S corporation, plus
- 2) Amounts borrowed for use in the activity either that the shareholder is personally liable for the repayment of, or for which the shareholder has pledged property not used in the activity as security.

To determine if the at-risk rules apply to an activity, the S corporation must identify each activity engaged in. When the S corporation is involved in more than one activity, and one or more of the activities incurs a loss for the year, the profit and loss of each activity is figured separately. The S corporation should provide each shareholder with a schedule that reflects that shareholder's part of gross income and deductions for each activity.

Separate activities must be combined and treated as one activity if:

- 1) The shareholder actively participates in the management of the trade or business, or
- 2) 65% or more of the losses from the operations are allocated to persons who actively participate in the management of the trade or business.

In addition, all activities involving tangible personal property leased or held for lease must be treated as one activity.

The at-risk rules do not apply to an activity of holding real property (other than mineral property) if the property was placed in service

before 1987, and the shareholder acquired the interest in the S corporation before 1987. However, the at-risk rules do apply to losses from an interest in an S corporation acquired after 1986, regardless of when the property used in the activity of holding real property was placed in service.

See Publication 925 for more information.

### Limit on Losses and Credits from Passive Activities

The limits on passive activity losses and credits may apply to losses and credits from an S corporation. These limits apply after the at-risk limits. Generally, a passive activity is any activity that involves the conduct of any trade or business in which the shareholder does not materially participate. It also includes any rental activity. However, if the taxpayer materially participates in a rental real estate activity and meets certain eligibility requirements, the rental activity is not a passive activity. See Publication 925 and the instructions for Form 1120S for information on how to report these activities to shareholders on Schedule K-1. Shareholders should see the *Shareholder's Instructions for Schedule K-1 (Form 1120S)*.

## Distributions to Shareholders

How S corporation distributions to a shareholder are taxed depends on whether the corporation has earnings and profits.

An S corporation is not considered to have earnings and profits for tax years beginning after 1982. However, the corporation may have accumulated earnings and profits from years before 1983 or from tax years before an S corporation election was made. For more information, see *S Corporation with Earnings and Profits*, later.

Distributions from an S corporation that does not have any earnings and profits generally will be a nontaxable return of the shareholder's basis in the corporate stock. However, if the distributions are more than the shareholder's adjusted basis in the stock, the excess is taxable as a sale or exchange of property. See *S Corporation with No Earnings and Profits*, later.

If the S corporation has earnings and profits, the distributions may be taxable dividends, a nontaxable return of basis, or taxable as a sale or exchange of property. See *S Corporation with Earnings and Profits*.

A shareholder who receives a distribution from an S corporation must wait until the close of the corporation's tax year to be able to figure the tax treatment of the distribution.

The S corporation's distributions may be in the form of cash or property.

If the corporation distributes cash, the shareholder uses the amount received to figure the tax effect and the adjusted basis of his or her stock.

If property other than cash is distributed, the amount the shareholder uses as a distribution is the fair market value of the property.

**Stock redemption.** A stock redemption occurs when a corporation reacquires its stock in exchange for property, whether or not the stock is cancelled, retired, or held as treasury stock. The property can be money, securities, or any property other than the corporation's stock or rights to such stock. A redemption is treated either as a distribution in part or full payment in exchange for the stock or as a distribution of property.

A redemption is treated as a distribution in payment for stock if any one of the following tests apply:

- 1) The redemption is substantially disproportionate with respect to the shareholder's actual or constructive holdings; (See *Substantially disproportionate distribution*, later.)
- 2) The redemption terminates the shareholder's entire interest in the corporation;
- 3) The redemption is not essentially equivalent to a dividend; or
- 4) The redemption is of stock held by a noncorporate shareholder and is made in partial liquidation of the redeeming corporation.

Gain or loss to a shareholder from a distribution that is a payment in exchange for stock is figured as if the redemption were a stock sale.

If the redemption payments are treated as a distribution of property, the amount paid that is treated as a dividend and the amount paid that is treated as a capital gain are determined as follows:

- 1) Subtract from the amount paid both any corporate liabilities assumed by the shareholder and any liability to which the distributed property is subject. Any **amount remaining**, but not more than the earnings and profits of the corporation, is treated as a dividend.
- 2) If the **amount remaining** in 1) above is more than the earnings and profits of the corporation, subtract from the **amount remaining** both the earnings and profits of the corporation and the shareholder's adjusted basis in the stock. The result, if more than zero, is treated as a capital gain.

**Substantially disproportionate distribution.** A distribution is substantially disproportionate if:

- 1) The ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time, is less than 80% of—
- 2) The ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at that time.

**Distributions not substantially disproportionate.** The distribution will not be treated as

substantially disproportionate unless immediately after the redemption the shareholder owns less than 50% of the total combined voting power of all classes of stock entitled to vote.

The distribution is also not treated as being substantially disproportionate, if the redemption is made under a plan whose purpose or effect is a series of redemptions which result in the aggregate in a distribution which is not substantially disproportionate to the shareholder.

**Appreciated property distributions.** If an S corporation distributes appreciated property, the S corporation will be treated as if it had sold the property to the shareholders at fair market value. Appreciated property is S corporation property that has a fair market value that is more than its adjusted basis to the S corporation.

The amount the shareholder uses as a value to figure the tax treatment of the property distribution is the fair market value at the date of distribution.

## S Corporation with No Earnings and Profits

If the S corporation has no earnings and profits, any distribution a shareholder receives is a return of basis in the shareholder's stock in the S corporation. The distribution will either reduce the adjusted basis of his or her stock in the S corporation or be a gain from the sale of property.

At the close of an S corporation's tax year, the shareholder must adjust his or her basis in the S corporation stock for all increases and decreases listed earlier under *Adjustments to Basis of Shareholder's Stock*. This does not include the decrease to adjusted basis for any distributions during the S corporation's tax year.

The shareholder then uses this adjusted basis to figure the tax treatment of any distributions received during the S corporation's tax year.

If the distributions are **less than or equal to** the adjusted basis, they are a return of capital. The adjusted basis of the shareholder's stock after being reduced for the distributions is next year's beginning adjusted basis.

If the distributions are **more than** the adjusted basis of the shareholder's stock, the excess is a gain from the sale or exchange of property. As such, the gain is generally long- or short-term capital gain. For purposes of the limits on losses and credits from passive activities, the gain is treated as gain from the sale or exchange of the S corporation stock. The next year's beginning basis for shareholder's stock is zero.

**Example.** Acme, an S corporation, has no earnings and profits. Acme distributes \$80,000 to its only shareholder, Betty. Her adjusted basis in the stock is \$50,000. The amount of the distribution that is more than her adjusted basis in the stock, \$30,000 (\$80,000 – \$50,000), is taxable as a gain from the sale or exchange of property.

## S Corporation with Earnings and Profits

The existence of earnings and profits is important to an S corporation if it has passive investment income or makes distributions. The presence of earnings and profits can mean that a distribution is a taxable dividend or the corporation is liable for a tax on its excess net passive income. See *Tax on Excess Net Passive Income*, earlier.

An S corporation is not considered to have earnings and profits for tax years beginning after 1982 in which it was an S corporation. However, an S corporation can have earnings and profits from:

- 1) Tax years in which the corporation was not an S corporation,
- 2) Any of the S corporation's tax years that began before 1983, or
- 3) A corporate acquisition that results in a carryover of earnings and profits under section 381 of the Internal Revenue Code.

Earnings and profits can be reduced by an S corporation for payment of the tax from recomputing a prior-year investment credit. This reduction of earnings and profits may affect the tax treatment of distributions by an S corporation to its shareholders.

If an S corporation has earnings and profits, it may also have previously taxed income. In that case, a shareholder's treatment of a distribution is more complex than the treatment described earlier for S corporations with no earnings and profits. There is a general treatment for distributions of S corporations with earnings and profits and previously taxed income and another treatment for S corporations that elect, with the consent of their shareholders, to first distribute earnings and profits.

**Retained earnings accounts.** Retained earnings accounts contain any accumulated earnings and profits (E&P) of the corporation. If the corporation has accumulated earnings and profits, it must maintain separate accounts for previously taxed income (PTI) and the accumulated adjustments account (AAA). If the accumulated E&P was accumulated before the corporation became an S corporation, the corporation may be liable for the tax imposed on excess net passive income, discussed earlier.

If a corporation has accumulated E&P, the retained earnings and accumulated E&P usually will not be the same because of the special rules for figuring retained earnings. If the E&P was accumulated after the corporation became an S corporation, the rules in effect before 1983 would apply in figuring accumulated E&P.

### Shareholder's treatment of distributions.

If an S corporation has earnings and profits but has not elected to treat distributions as coming from them first, discussed later, any distribution it makes will come from one or more of the sources described below.

The sources, their order of application, and their tax effect are as follows: Distributions made by an S corporation with accumulated earnings and profits.

**First**, treat the distribution as coming out of the accumulated adjustments account (AAA), to the extent of the AAA.

The portion of the distribution that is not more than the AAA is treated the same as a distribution from an S corporation with no earnings and profits. That is, the distribution is first applied as a nontaxable return of basis in the shareholder's stock in the S corporation.

This return of basis reduces the adjusted basis of a shareholder's stock in the S corporation.

Any amount of the distribution that is more than the shareholder's basis is then treated as a gain from the sale or exchange of property.

The AAA is decreased (but not below zero) by the amount of the distribution treated as coming from it.

**Second**, treat that portion of the distribution which remains after applying the First step above as a dividend to the extent it is not more than the accumulated earnings and profits of the S corporation.

**Third**, any excess, after applying the Second step above, is treated as if the S corporation had no earnings and profits. The distribution reduces any remaining basis of the shareholder's stock and any excess is treated as payment in exchange for stock. See *S Corporation with No Earnings and Profits*, earlier.

Order of distribution when S corporation has earnings and profits and pre-1983 previously taxed income (PTI):

**First**, treat the distributions as made out of the AAA to the extent of that account. Treat that portion that does not exceed the AAA the same as a distribution from an S corporation with no earnings and profits. See the First item under the previous discussion.

**Second**, treat any cash distributions as coming out of PTI from S corporation tax years beginning before 1983, after the distributions have reduced the AAA to zero. This portion of the distribution is treated the same as a distribution by an S corporation with no earnings and profits. These amounts will then reduce the shareholder's basis in the stock and in his or her PTI account. The distribution of cash cannot be more than the shareholder's net share immediately before the distribution of the corporation's PTI. The AAA and the earnings and profits of the corporation are not decreased by this portion of the distribution.

**Third**, once the distributions have reduced the PTI to zero, any excess is treated as a dividend to the extent of earnings and profits.

**Fourth**, any excess, after applying the Third step above, is treated as if the S corporation had no earnings and profits. Where an S corporation has no accumulated earnings and profits, the distributions are not included in gross income to the extent that the distributions are not more than the shareholder's adjusted basis in the stock. Any amount that a shareholder receives that is more than his or her basis in the stock is taxed as gain from the sale or exchange of property.

**Accumulated adjustments account (AAA).** The S corporation should maintain an AAA, which is adjusted each year for income, losses, and expenses. The AAA is adjusted in a similar way as the shareholder's basis in the stock of the S corporation, except that no adjustment is made for tax-exempt income or related expenses.

On the first day of an S corporation's first tax year that begins after 1982, the balance of the corporation's AAA is zero. The balance of the corporation's AAA at the end of the tax year can be a negative amount. Income in a later year will make the account positive only after the negative balance has been restored.

If an S corporation redeems stock and treats the redemption distribution as an exchange, the corporation's AAA is adjusted in an amount equal to the ratable share of the corporation's AAA (whether negative or positive) attributable to the redeemed stock as of the date of the redemption.

If an S corporation redeems stock in a redemption that is treated as a distribution of property, and the proceeds from the redemption are distributed to the shareholders, the AAA is decreased (but not below zero) by the full amount of the distribution.

**Previously taxed income (PTI).** The previously taxed income account relates to the rules used for Subchapter S corporations before the Subchapter S Revision Act of 1982 became effective. PTI is personal to a shareholder and cannot be transferred to another shareholder. If the S corporation has earnings and profits, a distribution from PTI is important to a shareholder because an S corporation shareholder who has PTI may receive a nontaxable distribution from PTI. The distribution from PTI comes after a distribution from AAA and before a dividend distribution from earnings and profits.

A distribution of PTI will reduce the shareholder's basis in the S corporation stock and the balance of the shareholder's PTI account.

**Example.** Cord, an S corporation, has accumulated earnings and profits of \$10,000. It distributes \$80,000 to its only shareholder, Don. His basis in the stock is \$50,000. Cord has \$30,000 in its AAA. The order of distributions and how they are taxed follow:

Distribution	Source	Type of Distribution	Taxable Yes/No
\$80,000 (30,000)	From AAA	Reduction in basis	No
\$50,000 (10,000)	From E & P	Dividend	Yes
\$40,000 (20,000)	Remaining basis	Reduction in basis	No
\$20,000 (20,000)	Excess of basis	Sale or exchange of property	Yes
-0-			

The corporation reports a \$10,000 dividend to the shareholder on Form 1099-DIV, *Dividends and Distributions*, and \$70,000 in property distributions on Schedule K-1, *Shareholder's Share of Income, Credits, Deductions, etc.*

See the discussion on *Adjustments to basis of shareholder's stock* under *Figuring Shareholder Taxable Income*, earlier.

**Election to first distribute earnings and profits.** For any tax year, an S corporation can elect its distributions as coming first from earnings and profits if all shareholders who receive a distribution during the tax year consent to the election.

The shareholder's consent to the election is effective only for the tax year for which it is made. If the corporation makes an effective election, each shareholder will report a dividend in the amount of the distribution that is treated as coming out of earnings and profits. After the earnings and profits are completely distributed, any future distributions are generally treated as explained earlier under *S Corporation with No Earnings and Profits*.

If the S corporation with previously taxed income elects to distribute earnings and profits first for the tax year, and does not make the election to forego previously taxed income, the distributions are treated as made:

- First, from previously taxed income;
- Second, from earnings and profits; and
- Third, from the AAA.

Any portion of the distribution that remains after the previously taxed income, earnings and profits, and the AAA are exhausted is treated as a distribution from an S corporation that has no earnings and profits.

If the S corporation making the election to distribute earnings and profits first has both Subchapter C earnings and profits and Subchapter S earnings and profits in a tax year of the corporation in which the distribution is made, the distributions are treated as made:

- First from Subchapter C earnings and profits, and
- Second from Subchapter S earnings and profits.

Subchapter S earnings and profits are earnings and profits accumulated in a tax year beginning before January 1, 1983, for which a Subchapter S election was in effect.



If the S corporation does not completely distribute earnings and profits in the first tax year in which it makes the election and wishes to make the same election for the next year, it must repeat the election and again obtain the necessary consents from the shareholders who receive the distributions.

**Distributions during a post-termination transition period.** Generally, distributions of money during a post-termination transition period by a former S corporation to its shareholders reduce the shareholders' adjusted bases in their stock up to the amount in the accumulated adjustments account (AAA). The former S corporation can elect, with the consent of all its shareholders to whom distributions are made (whether or not they are cash distributions) during this period, to have all distributions of money treated as dividends up to the amount of the corporation's earnings and profits. Distributions that are more than the corporation's earnings and profits reduce the shareholders' adjusted bases in their stock. See *S Corporation with Earnings and Profits*, earlier.

The corporation makes this election by attaching a statement to its Form 1120 for the year in which the post-termination transition period ends that clearly indicates the corporation elects to have section 1371(e)(1) not apply to all distributions made during this period. The statement must be signed by a person authorized to sign the corporation return and by all the shareholders that must consent to the election.

**Post-termination transition period.** The post-termination transition period is the period beginning on the day after the last day of the corporation's last tax year as an S corporation and ending on the later of:

- 1) The day which is 1 year after such last day, or
- 2) The due date for the last S corporation return (including extensions), and

The 120 days beginning on the date a determination that the S corporation's election had terminated for a previous tax year. (A determination means a court decision that becomes final, a closing agreement, or an agreement between the corporation and the IRS that the corporation did not qualify.)

## Terminating S Corporation Status

The corporation's status as an S corporation can be terminated in any of the following ways:

- 1) By revoking the election.
- 2) By ceasing to qualify as an S corporation.
- 3) By violating the passive investment income restrictions on S corporations with pre-S corporation earnings and profits for three consecutive tax years.

**Five-year waiting period.** If a corporation's status as an S corporation has been terminated, it generally must wait 5 tax years before

it can again become an S corporation. If it gets the permission of the IRS, the waiting period can be less than 5 years.

## Revoking S Corporation Status

An S corporation election can be revoked by the corporation for any tax year. It can be revoked only if shareholders who collectively own more than 50% of the outstanding shares in the S corporation's stock (including any nonvoting stock) consent to the revocation. The consenting shareholders must own their stock in the S corporation at the time the revocation is made.

**How to revoke.** The revocation must be made by the corporation in the form of a statement. The statement must provide:

- 1) That the corporation is revoking its election to be treated as an S corporation under section 1362(a) of the Internal Revenue Code,
- 2) The name, address, and taxpayer identification number of the corporation,
- 3) The number of shares of stock (including nonvoting stock) outstanding at the time the revocation is made, and
- 4) The date the revocation is to be effective for revocations that specify a prospective revocation date.

This statement must be signed by any person authorized to sign the S corporation return. It must be sent to the service center where the corporation filed its election to be an S corporation.

To this statement of revocation, the corporation should attach a statement of consent, which must be signed by each shareholder, under penalties of perjury, who consents to the revocation. It must also provide the name, address, and taxpayer identification number of each shareholder, the number of shares of outstanding stock (including nonvoting stock) each shareholder holds at the time the revocation is made, the date or dates the stock was acquired, the date the shareholder's tax year ends, the name and taxpayer identification number of the S corporation, and the election to which the shareholder consents.

**Effective date of revocation.** The revocation is effective:

- 1) On the first day of the tax year if the revocation is made by the 15th day of the 3rd month of the same tax year.
- 2) On the first day of the following tax year if the revocation is made after the 15th day of the 3rd month of a tax year.
- 3) On the date specified if the revocation specifies a date on or after the day the revocation is made.

A corporation that specifies a prospective date for revocation that is other than the first day of the tax year will create an S termination year.

See *S Termination Year*, later, for information on filing returns for the S termination year.

## Ceasing To Qualify

A corporation's status as an S corporation will be terminated if at any time the corporation ceases to qualify as an S corporation. If the corporation inadvertently ceases to qualify, see the later discussion of *Inadvertent Termination*.

Certain events can cause the corporation to cease qualifying as an S corporation. Some of these include:

- 1) Having more than 35 shareholders,
- 2) Transferring stock in the S corporation to
  - A corporation,
  - A partnership,
  - An ineligible trust, or
  - A nonresident alien,
- 3) Creating a second class of stock, and
- 4) Acquiring a subsidiary, other than certain nonoperating subsidiaries.

**Effective date of termination.** A termination of S corporation status will be effective as of the date the terminating event occurred.

A corporation that ceases to be a small business corporation on a date other than the first day of the tax year will create an S termination year. For more information on filing tax returns for the S termination year, see *S Termination Year*, later.

## Violating the Passive Income Restriction

A corporation's status as an S corporation will be terminated if both of the following conditions occur for 3 consecutive tax years:

- 1) It has pre-S corporation earnings and profits at the end of each tax year.
- 2) Its passive investment income for each tax year is more than 25% of gross receipts. (Passive investment income and gross receipts are figured as explained earlier under *Tax on Excess Net Passive Income*.)

**Effective date of termination.** A termination of S corporation status because of a violation of the passive income restriction will be effective on the first day of the tax year that follows the third consecutive tax year referred to above. See also *Inadvertent Termination*, discussed later.

## S Termination Year

Any termination previously described in *Revoking S Corporation Status* and *Ceasing To Qualify* that is effective during the tax year on a date other than the first day of that tax year will create an S termination year. The part of the S termination year ending on the date before the effective date of the termination is an 1120S (S corporation) short tax year. The part of the S termination year beginning on the first day on which the termination is effective is an 1120 (C corporation) short tax year.

After the S termination year is divided into an 1120S short year and an 1120 short year, the separately stated items of income, loss, credit, and deduction, and the amount of the nonseparately stated income or loss must be divided between the periods. There are two methods that can be used to make this division. They are:

- 1) A pro rata allocation, or
- 2) An allocation based on normal tax accounting rules.

After the separately stated items and the nonseparately stated income or loss are divided, one set of amounts is used for the 1120S short year and the other set of amounts is used for the 1120 short year.

The corporation will have to file two returns to cover the S termination year. One covers the 1120S short year and one covers the 1120 short year. The S termination year will count only as one tax year for figuring carrybacks and carryovers, even though two returns are filed for the year.

**Pro rata allocation.** Generally, a pro rata allocation must be used unless the shareholders and S corporation specifically indicate they choose to use the other allocation method.

The pro rata allocation is made in the following way:

- 1) Determine for the entire S termination year the amount of each separately stated item of income, loss, deduction, or credit and the amount of the nonseparately stated income or loss.
- 2) Divide each amount by the number of days in the S termination year.
- 3) Multiply the amounts from step (2) by the number of days in the Form 1120S short year. These amounts are used for the Form 1120S filed for the 1120S short year.
- 4) Multiply the amounts from step (2) by the number of days in the 1120 short year. These amounts are used for the Form 1120 filed for the 1120 short year.

The pro rata allocation cannot be made to any item that results from a corporation's election to treat a stock purchase as an asset purchase.

The pro rata allocation cannot be made if 50% or more of the corporation's stock is sold or exchanged during the S termination year.

**Allocation based on normal accounting rules.** A corporation can elect an allocation based on normal accounting rules. All persons who are, or were, shareholders at any time during the 1120S short year and on the first day of the 1120 short year must consent to the choice.

The corporation makes this choice by filing a statement with the return for the 1120 short year, which includes the following:

- 1) That it chooses under section 1362(e)(3) of the Internal Revenue Code not to apply the rules in section 1362(e)(2), but to allocate its termination year income on the

basis of its normal tax accounting method.

- 2) The name, address, and taxpayer identification number of the corporation.
- 3) The cause and date of the termination.
- 4) The signature of the person authorized to sign Form 1120S.
- 5) A separate statement of consent signed (under penalty of perjury) by each person who is, or was, a shareholder at any time during the 1120S short year and on the first day of the 1120 short year. The statement of consent must include the name, address, and taxpayer identification number of each shareholder, the number of shares owned by the shareholder, the dates they were acquired, the date on which the shareholder's tax year ends, the S corporation's name and taxpayer identification number, and the election to which the shareholder consents.

Under the alternate method of allocation, the corporation reports all items of income, loss, deduction, or credit based on the corporation's books and records (including worksheets). The items will be split between the 1120S short year and the 1120 short year according to the time they were realized or incurred based on the corporation's books and records.

The alternate method of allocation must be used if 50% or more of the corporation's stock is sold or exchanged during the S termination year.

**Return for 1120S short year.** Form 1120S for the 1120S short year is due at the same time as Form 1120 is due for the 1120 short year, including extensions.

**Return for 1120 short year.** To figure the tax on the Form 1120 for the 1120 short year, the taxable income for the 1120 short year must be annualized.

This annualization is done in the following way:

- 1) Multiply the taxable income for the 1120 short year by the number of days in the S termination year.
- 2) Divide the amount from step (1) by the number of days in the 1120 short year.
- 3) Figure the tax on the amount from step (2).
- 4) Multiply the tax from step (3) by the number of days in the 1120 short year.
- 5) Divide the amount from step (4) by the number of days in the S termination year.

To figure the corporate alternative minimum tax for the short year, make the following adjustments:

- 1) The alternative minimum taxable income for the short period is placed on an annual basis by multiplying that amount by 12 and dividing the result by the number of months in the short period, and

- 2) The tentative minimum tax for the tax year will have the same relation to the tax figured on the annual basis as the number of months in the short period has to 12.

For more information on the alternative minimum tax, see Publication 542.

## Inadvertent Termination

If the corporation is terminated because it ceased to qualify as an S corporation, or because it violated the restriction on passive investment income, the IRS can waive the termination. The termination can be waived if:

- 1) The IRS determines that the termination was inadvertent,
- 2) The corporation takes steps to correct the terminating event within a reasonable period of time after discovering it, and
- 3) The corporation and its shareholders agree to any adjustments the IRS may require.

For example, a corporation determined in good faith that it had no pre-S corporation earnings and profits. It was later found on audit that its S corporation status was terminated because the corporation had violated the passive investment income test and had pre-S corporation accumulated earnings for 3 consecutive years. In such a situation, the IRS may find that the terminating event was inadvertent.

The corporation can request a ruling to determine whether the termination was inadvertent by following the procedures set out in Revenue Procedure 95-1, 1995-1 I.R.B. There is a fee for requesting this ruling. For more information and a schedule of fees, get Publication 1375.

The request should set forth all relevant facts pertaining to the terminating event, including the date of the corporation's election to be an S corporation, a detailed explanation of the event causing termination, when and how the event was discovered, and the steps taken to return the corporation to small business corporation status.

Such ruling requests should be sent to:

The Internal Revenue Service  
Associate Chief Counsel (Domestic)  
Attention:CC:DOM:CORP:T  
P.O. Box 7604  
Ben Franklin Station  
Washington, DC 20044

The package should be marked "Ruling Request Submission."

However, a corporation can apply for automatic inadvertent termination relief if its S corporation status is terminated solely because the stock of the corporation was transferred to a trust whose current income beneficiary (or the legal representative of the current income beneficiary) inadvertently failed to file a timely election to be a "qualified subchapter S trust." The S corporation must still meet the criteria for S corporation status. Revenue Procedure 94-23 details the procedural requirements for obtaining this relief and is in lieu of the letter

ruling procedure. No user fees apply to corrective action taken under this procedure. You can read the full text of this revenue procedure at most IRS offices and at many public libraries.

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## Sample Return

StratoTech Inc., is a distributor of machinery, equipment, and supplies for the building trades. It uses an accrual method of accounting and files its returns on the calendar year. In December 1994, StratoTech Inc., made a timely and proper election to be treated as an S corporation.

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## Page 1

When the corporation's return is prepared for 1995, the preaddressed label sent to the corporation by the IRS should be used. The preaddressed label is designed to expedite processing and prevent errors. If the corporation does not have such a label, the corporation's name, street address, room number, suite, or unit, and city, state, and ZIP code should be entered in the appropriate spaces on the first page. After entering the identifying information at the top of the page, StratoTech's items of income and deductions are then reported in summary form.

The name and employer identification number of the corporation is shown in the top margin of all schedules and other attachments to Form 1120S.

**Line items.** All applicable items for income, deductions, and tax listed on page 1 of Form 1120S are filled in, even though totals can be shown in schedules attached to the return. Do not alter, substitute, or cross out the line captions printed on the official return forms.

**Line 1.** Gross sales for the year totaled \$1,545,700 (line 1a), determined on the accrual method of accounting. After subtracting returned goods and allowances of \$21,000 (line 1b), net sales of \$1,524,700 are entered on line 1c.

**Line 2.** Cost of goods sold is deducted on line 2. This figure, \$954,700, is the total from Schedule A (line 8) on page 2.

**Line 3.** Net sales minus cost of goods sold result in gross profit of \$570,000.

**Line 6.** Total income on line 6 is \$570,000.

**Line 7.** The salaries of the company president, vice president, and secretary-treasurer total \$170,000 and are included on line 7. Compensation paid to corporate officers must be separated from other salaries and wages and must be entered on line 7 rather than on line 8.

**Line 8.** Other salaries and wages are entered on line 8. The entry includes only salaries and wages not included on line 7 and not deducted as part of cost of goods sold. Salaries and wages of \$144,000 on line 8 are reduced by \$6,000, the amount of the employment credits, discussed later, passed through to the shareholders.

**Line 9.** Repairs include only payments for items that do not add to the value of the assets repaired or substantially increase their useful lives. StratoTech incurred \$800 for repairs.

**Line 10.** StratoTech must use the specific charge-off method for bad debts. Actual accounts written off during the year total \$1,600.

**Line 11.** Rental expense for StratoTech's office and service building is \$9,200 for the year.

**Line 12.** Deductible taxes total \$15,000.

**Line 13.** Interest expense accrued during the year amounts to \$14,200. This includes interest on debts for business operations only. Interest of \$850 to carry tax-exempt securities and investments is not included. Interest on the debt to carry investments that produce taxable income is \$3,000. It is shown on line 11a of Schedule K and passed through to the shareholders on Schedule K-1.

**Lines 14a and 14b.** Depreciation of \$15,200 is brought forward from Form 4562, *Depreciation and Amortization* (not illustrated). If StratoTech had a section 179 deduction, it would not be included here. It is passed through to the shareholders on Schedule K-1.

**Line 16.** Advertising expense of \$8,700 is entered on line 16.

**Line 19.** Other ordinary and necessary business deductions total \$78,300. These include miscellaneous office expenses, sales commissions, legal fees, etc. A schedule itemizing these expenses must be attached to the return, even though it is not shown.

**Line 20.** Total deductions are \$451,000.

**Line 21.** Ordinary income (nonseparately stated income) is \$119,000.

**Corporate officer's signature.** The corporation return must be signed manually by the corporate officer authorized to sign. Use of the corporate seal is optional.

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## Page 2

**Schedule A.** Schedule A is used to report the cost of goods sold. This figure is beginning inventory plus merchandise bought or produced during the year minus ending inventory.

**Line 1.** Because it is a distributor, StratoTech accounts for its purchasing costs as part of the cost of goods sold. Goods on hand at the beginning of the year were properly valued at \$126,000, using the lower of cost or market valuation method. StratoTech reports this amount on line 1.

**Line 2.** Purchases cost of \$1,127,100 is reported on line 2.

**Line 7.** StratoTech had goods on hand at the end of the year properly valued at \$298,400. StratoTech reports that amount on line 7.

**Lines 9a-9e.** All applicable questions on these lines should be answered.

**Schedule B.** All applicable questions in this section should be answered and the appropriate boxes checked.

**Designation of tax matters person.** Information relating to the shareholder designated as the tax matters person should be provided as indicated at the bottom of page 2, Form 1120S. For information on the rules for designating a tax matters person (TMP), see Temporary Income Tax Regulation 301.6231(a)(7)-1T.

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## Page 3

**Schedule K.** Schedule K summarizes the corporation's income, deductions, credits, etc., that are reportable by the shareholders.

**Line 1.** On line 1, StratoTech shows the ordinary income (nonseparately stated income) of \$119,000 from line 21, page 1.

**Line 4.** Line 4 is used to report portfolio income and loss items. Portfolio items include interest income, dividend income, royalty income, short-term capital gain or loss, and long-term capital gain or loss. StratoTech had the following portfolio items:

- 1) Taxable interest income of \$4,000 reportable on **line 4a**, and
- 2) Taxable dividends of \$16,000 reportable on **line 4b**.

**Line 7.** Line 7 is for charitable contributions. During 1995, StratoTech contributed \$11,400 to the United Community Fund and \$12,600 to the State University Scholarship Fund. The total of \$24,000 is entered on line 7.

**Lines 11a and 11b(1).** These lines show the items that must be taken into account by shareholders to figure their interest deduction on investment indebtedness. **Line 11a** is used for investment interest expense. StratoTech had investment interest expense of \$3,000. **Line 11b(1)** is for investment income. StratoTech had taxable interest from investments (line 4a) totaling \$4,000. StratoTech also had dividends from investments (line 4b) totaling \$16,000. StratoTech enters \$20,000 on line 11b(1). Each shareholder's share of these items must be reported on Schedule K-1.

**Line 13.** Line 13 is for the employment credits. StratoTech has \$6,000 of jobs credits in 1995. The credit was figured on Form 5884, *Jobs Credit* (not shown here).

**Line 17.** Tax-exempt interest is entered on line 17. StratoTech earned \$5,000 of tax-exempt interest from state bonds.

**Line 19.** StratoTech had \$16,350 of non-deductible expenses, consisting of \$9,500 for premiums paid on term life insurance for corporate officers, \$850 for interest paid to purchase tax-exempt securities, and \$6,000 reduction of salaries due to the jobs credit.

**Line 20.** Line 20 is for distributions other than those reported on line 22. StratoTech distributed \$65,000 in 1995.

**Line 23.** Income of \$112,000 is entered here. This is the total of Schedule K lines 1, 4a, and 4b minus the amounts on lines 7 and 11a. The amount is the same as that on line 8 of Schedule M-1.

**Schedule K-1.** A separate Schedule K-1 is completed by the S corporation for each shareholder.

Generally, shareholders must treat items of income, loss, deduction, credit, etc., on their returns consistent with the way the S corporation reported them on its return. A shareholder who shows the items differently from the way the S corporation reported them on Schedule K-1 should complete Form 8082.

A copy of each shareholder's Schedule K-1 should be filed with Form 1120S. A copy is kept as a part of the corporation's records, and each shareholder receives a copy with instructions attached.

StratoTech must prepare a Schedule K-1 for each shareholder. The illustrated Schedule K-1 is for John H. Green who owns 9,000 shares (45%) of the corporation's stock, which he acquired on March 3, 1976. He devotes 100% of his time to the business for which he is paid \$40,000.

Lines 1 through 10 are for each shareholder's distributive share of nonseparately stated income or loss and separately stated income or loss and deductions.

**Line 1.** Line 1 shows Mr. Green's share of nonseparately stated income of \$53,550 (45% × \$119,000). It makes no difference whether this income was distributed to him in 1995. He must report \$53,550 on Schedule E (Form 1040) when he files his individual income tax return, Form 1040.

**Line 4.** Line 4 is for portfolio income and loss items. Mr. Green's share of interest income is \$1,800 (45% × \$4,000). His share of dividend income is \$7,200 (45% × \$16,000).

**Line 7.** Line 7 is for Mr. Green's share of StratoTech's charitable contributions for 1995. His share is \$10,800 (45% × \$24,000). Because all StratoTech's contributions were given to public charities, they qualify for the 50% limitation.

**Lines 11a and 11b(1).** These lines are used to show each shareholder's share of interest on investment indebtedness. The amounts reported on these lines will be used to complete Form 4952, *Investment Interest Expense Deduction*. **Line 11a** shows Mr. Green's share of StratoTech's investment interest expense, \$1,350 (45% × \$3,000). Investment interest expense is that part of StratoTech's total interest for loans made to carry its investment. **Line 11b(1)** shows Mr. Green's share of StratoTech's investment income, \$9,000 (45% × \$20,000). This represents StratoTech's income from ordinary dividends and interest. It does not include interest on municipal bond investments, which is tax-exempt.

**Line 13.** Line 13 is for the employment credits. Mr. Green's share of StratoTech's employment credits is \$2,700 (45% × \$6,000).

**Line 17.** In 1995, StratoTech had \$5,000 of tax-exempt interest from state bonds. Mr. Green's 45% share of the tax-exempt interest is \$2,250 (45% × \$5,000). This amount is entered on line 17.

**Line 19.** Mr. Green's 45% share of nondeductible expenses is \$7,358 (45% × \$16,350). This amount is entered on line 19.

**Line 20.** Line 20 is for distributions paid during the year other than those paid from accumulated earnings and profits and reported on Form 1099-DIV. During 1995, StratoTech distributed \$65,000. Mr. Green's 45% share of the distribution is \$29,250 (45% × \$65,000).

## Page 4

**Schedule L.** Comparative balance sheets for the beginning and end of the tax year are shown on Schedule L. The balance sheets should agree with the S corporation's books and records. Entries on this page should also agree with amounts shown elsewhere on the return. For example, the figures for beginning and ending inventories must be the same as those appearing in the analysis of cost of goods sold. In addition, the figures on the balance sheet for the beginning of the tax year will normally agree with the balance sheet figures for the end of the last tax year.

**Schedules M-1 and M-2.** These schedules must be completed if the total assets (line 15, column (d), Schedule L) are \$25,000 or more. To properly complete these schedules, additional information must be obtained from the corporation's books and records.

The following appeared on the books of StratoTech for the calendar year 1995.

Account	Debit	Credit
Gross sales .....		\$1,545,700
Sales returns and allowances .....	\$ 21,000	
Cost of goods sold .....	954,700	
Dividend income .....		16,000
Interest income:		
On state bonds .....		5,000
Other—taxable .....		4,000
Premiums on life insurance .....	9,500	
Compensation of officers .....	170,000	
Salaries and wages .....	144,000	
Repairs .....	800	
Bad debts .....	1,600	
Rental expense .....	9,200	
Taxes .....	15,000	
Interest expense:		
Loan—tax-exempt bonds \$ 850		
Other .....	17,200	18,050
Contributions .....	24,000	
Depreciation .....	9,580	
Advertising .....	8,700	
Other expenses of operation .....	78,300	
Net income per books	106,270	
<b>Total</b>	<b>\$1,570,700</b>	<b>\$1,570,700</b>

**Schedule M-1.** Schedule M-1 starts with the net income per books as shown in the corporation's books and records. It provides for necessary adjustments to reconcile this amount with the income shown on line 23, Schedule K.

**Line 1.** Line 1 is the net income per books, \$106,270, shown on the corporation's books.

**Line 2.** Line 2 should show all income and credits included in income subject to tax that are not recorded on the books for this year. This can happen if assets are valued on the corporate books at an amount greater than that used for tax purposes. When these assets are sold, the gain included in taxable income is greater than that recorded on the books, and the difference is shown here.

**Line 3.** Line 3 is for expenses recorded on the corporation's books that cannot be deducted. They are shown in an itemized statement attached to the return (not illustrated). It would include the following:

Premiums paid on term life insurance on corporate officers .....	\$ 9,500
Interest paid to purchase tax-exempt securities .....	850
Reduction of salaries due to jobs credit	6,000
<b>Total</b>	<b>\$16,350</b>

**Line 4.** The total of lines 1 through 3, \$122,620, goes on line 4.

**Line 5.** Line 5 shows nontaxable income recorded on the corporation's books during the year that is not on the return. This totals \$5,000, the interest on state bonds.

**Line 6.** Line 6 includes all deductions claimed for tax purposes that are not recorded on the corporation's books. StratoTech enters \$5,620 on line 6a. This represents the difference between depreciation claimed on the tax return and the corporation's books. If the corporation had other deductions to itemize on this line and there was not enough space on the line, it would have to attach a statement to the return listing them.

**Line 7.** The total of lines 5 and 6, \$10,620, goes on line 7.

**Line 8.** The difference, \$112,000, between lines 4 and 7 must agree with line 23, Schedule K.

**Schedule M-2.** Schedule M-2 provides an analysis of certain earned equity accounts of the corporation for the tax year. The schedule shows the changes to the equity accounts for the income, deductions, distributions, etc., that are reported on the return for the tax year.

**Column (a), Line 1.** The first column is the accumulated adjustments account. For an S corporation's first year beginning after 1982, the initial balance in the account is zero. StratoTech enters zero on line 1.

**Line 2.** StratoTech's ordinary income for 1995 (page 1, line 21) is \$119,000. This is entered on line 2.

**Line 3.** StratoTech enters \$20,000 (\$16,000 dividends plus \$4,000 interest) on line 3. This is made up of amounts on lines 4a and 4b of Schedule K.

**Line 4.** Line 4 is for any loss shown on page 1, line 21. Because StratoTech has no losses in 1995, line 4 is zero.

**Line 5.** StratoTech enters \$42,500 on line 5. This is made up of \$3,000 interest on a loan to carry investments, \$6,000 reduction in salaries and wages due to the employment credits, \$9,500 for premiums paid on term life insurance for corporate officers, and \$24,000 charitable contributions.

**Line 6.** Line 6 is the total of lines 1 through 5, or \$96,500.

**Line 7.** Line 7 is for distributions other than dividend distributions. StratoTech enters \$65,000 on this line.

**Line 8.** Line 8 shows the balance in the accumulated adjustments account at the end of the year. StratoTech subtracts line 7 from line 6 and enters \$31,500 here.

**Column (b), Line 1.** The second column is the other adjustments account. It is for other items, such as tax-exempt income and related expenses. The balance at the beginning of the year is zero. This is entered on line 1.

**Line 3.** StratoTech had \$5,000 of tax-free interest income from state bonds. This amount is entered on line 3.

**Line 5.** Line 5 is the nondeductible interest paid to purchase tax-exempt securities. StratoTech enters \$850 on this line.

**Line 6.** The total of lines 1 through 5, \$4,150, is entered on line 6.

**Line 7.** Because the total distributions, other than dividends, were not more than the

balance in the accumulated adjustments account, none of the distribution is applied to the other adjustments account. StratoTech enters zero on line 7.

**Line 8.** The balance in the other adjustments account at the end of the year is \$4,150. StratoTech enters this amount here.

**Column (c).** The third column is for undistributed taxable income that was included in shareholders' income for years that began before 1995. Since this is StratoTech's first year as an S corporation, there are no entries in this column.

Department of the Treasury  
Internal Revenue Service

▶ Do not file this form unless the corporation has timely filed Form 2553 to elect to be an S corporation.

▶ See separate instructions.

**1995**

For calendar year 1995, or tax year beginning 1995, and ending 19

<b>A</b> Date of election as an S corporation <b>12-1-94</b>	<b>Use IRS label. Otherwise, please print or type.</b> 10-4487965 DEC95 D74 3070 StratoTech, Inc. 482 Winston Street Metro City, OH 43705	<b>C</b> Employer identification number <b>10 4487965</b>
<b>B</b> Business code no. (see Specific Instructions) <b>5008</b>		<b>D</b> Date incorporated <b>3-1-75</b>
		<b>E</b> Total assets (see Specific Instructions) <b>\$ 771,334</b>

**F** Check applicable boxes: (1)  Initial return (2)  Final return (3)  Change in address (4)  Amended return

**G** Check this box if this S corporation is subject to the consolidated audit procedures of sections 6241 through 6245 (see instructions before checking this box)

**H** Enter number of shareholders in the corporation at end of the tax year **6**

**Caution: Include only trade or business income and expenses on lines 1a through 21. See the instructions for more information.**

	1a	b	c Bal	1c
<b>Income</b>	1a Gross receipts or sales <b>1,545,700</b>	Less returns and allowances <b>24,000</b>		<b>1,521,700</b>
2 Cost of goods sold (Schedule A, line 8)				<b>954,700</b>
3 Gross profit. Subtract line 2 from line 1c				<b>570,000</b>
4 Net gain (loss) from Form 4797, Part II, line 20 (attach Form 4797)				
5 Other income (loss) (attach schedule)				
6 Total income (loss). Combine lines 3 through 5				<b>570,000</b>
<b>Deductions (see page 10 of the instructions for limitations)</b>				
7 Compensation of officers				<b>170,000</b>
8 Salaries and wages (less employment credits)				<b>138,000</b>
9 Repairs and maintenance				<b>800</b>
10 Bad debts				<b>6,600</b>
11 Rents				<b>9,200</b>
12 Taxes and licenses				<b>15,000</b>
13 Interest				<b>14,200</b>
14a Depreciation (if required, attach Form 4582)	14a <b>15,200</b>			
b Depreciation claimed on Schedule A and elsewhere on return	14b			
c Subtract line 14b from line 14a				<b>15,200</b>
15 Depletion (Do not deduct oil and gas depletion.)				
16 Advertising				<b>8,700</b>
17 Pension, profit-sharing, etc., plans				
18 Employee benefit programs				
19 Other deductions (attach schedule)				<b>78,300</b>
20 Total deductions. Add the amounts shown in the far right column for lines 7 through 19				<b>451,000</b>
21 Ordinary income (loss) from trade or business activities. Subtract line 20 from line 6				<b>119,000</b>
<b>Tax and Payments</b>				
22 Tax: a Excess net passive income tax (attach schedule)	22a			
b Tax from Schedule D (Form 1120S)	22b			
c Add lines 22a and 22b (see page 13 of the instructions for additional taxes)				
23 Payments: a 1995 estimated tax payments and amount applied from 1994 return	23a			
b Tax deposited with Form 7004	23b			
c Credit for Federal tax paid on fuels (attach Form 4136)	23c			
d Add lines 23a through 23c				
24 Estimated tax penalty. Check if Form 2220 is attached <input type="checkbox"/>				
25 Tax due. If the total of lines 22c and 24 is larger than line 23d, enter amount owed. See page 3 of the instructions for depository method of payment				
26 Overpayment. If line 23d is larger than the total of lines 22c and 24, enter amount overpaid				
27 Enter amount of line 26 you want: Credited to 1996 estimated tax <input type="checkbox"/> Refunded <input type="checkbox"/>				

**Please Sign Here**

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer: John H. Green Date: 3/10/96 Title: President

<b>Paid Preparer's Use Only</b>	Preparer's signature	Date	Check if self-employed <input type="checkbox"/>	Preparer's social security number
	Firm's name (or yours if self-employed) and address	EIN	ZIP code	

**Schedule A Cost of Goods Sold** (see page 14 of the instructions)

1	Inventory at beginning of year	1	126,000	00
2	Purchases	2	1,127,100	00
3	Cost of labor	3		
4	Additional section 263A costs (attach schedule)	4		
5	Other costs (attach schedule)	5		
6	<b>Total.</b> Add lines 1 through 5	6	1,253,100	00
7	Inventory at end of year	7	298,400	00
8	<b>Cost of goods sold.</b> Subtract line 7 from line 6. Enter here and on page 1, line 2	8	954,700	00

- 9a Check all methods used for valuing closing inventory:
- (i)  Cost as described in Regulations section 1.471-3
  - (ii)  Lower of cost or market as described in Regulations section 1.471-4
  - (iii)  Other (specify method used and attach explanation) ▶
- b Check if there was a writedown of "subnormal" goods as described in Regulations section 1.471-2(c) ▶
- c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970). ▶
- d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO. 9d
- e Do the rules of section 263A (for property produced or acquired for resale) apply to the corporation?  Yes  No
- f Was there any change in determining quantities, cost, or valuations between opening and closing inventory?  Yes  No  
If "Yes," attach explanation.

**Schedule B Other Information**

- |   | Yes | No |
|---|-----|----|
| 1 Check method of accounting: (a) <input type="checkbox"/> Cash (b) <input checked="" type="checkbox"/> Accrual (c) <input type="checkbox"/> Other (specify) ▶  |     |    |
| 2 Refer to the list on page 24 of the instructions and state the corporation's principal:<br>(a) Business activity ▶ <u>Sales Distributor</u> (b) Product or service ▶ <u>heavy equipment</u>   |     |    |
| 3 Did the corporation at the end of the tax year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? (For rules of attribution, see section 267(c).) If "Yes," attach a schedule showing: (a) name, address, and employer identification number and (b) percentage owned.   |     | ✓  |
| 4 Was the corporation a member of a controlled group subject to the provisions of section 1561?   |     | ✓  |
| 5 At any time during calendar year 1995, did the corporation have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? (See page 14 of the instructions for exceptions and filing requirements for Form TD F 90-22.1.)<br>If "Yes," enter the name of the foreign country ▶   |     | ✓  |
| 6 Was the corporation the grantor of, or transferor to, a foreign trust that existed during the current tax year, whether or not the corporation had any beneficial interest in it? If "Yes," the corporation may have to file Forms 3520, 3520-A, or 926.  |     | ✓  |
| 7 Check this box if the corporation has filed or is required to file Form 8264, Application for Registration of a Tax Shelter. ▶ <input type="checkbox"/>   |     |    |
| 8 Check this box if the corporation issued publicly offered debt instruments with original issue discount. ▶ <input type="checkbox"/><br>If so, the corporation may have to file Form 8261, Information Return for Publicly Offered Original Issue Discount Instruments.  |     |    |
| 9 If the corporation: (a) filed its election to be an S corporation after 1986, (b) was a C corporation before it elected to be an S corporation or the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation, and (c) has net unrealized built-in gain (defined in section 1374(d)(1)) in excess of the net recognized built-in gain from prior years, enter the net unrealized built-in gain reduced by net recognized built-in gain from prior years (see page 14 of the instructions) ▶ <u>\$ 37,200</u> |     |    |
| 10 Check this box if the corporation had subchapter C earnings and profits at the close of the tax year (see page 15 of the instructions) ▶ <input type="checkbox"/>  |     |    |

**Designation of Tax Matters Person** (see page 15 of the instructions)

Enter below the shareholder designated as the tax matters person (TMP) for the tax year of this return:

Name of designated TMP ▶ John H. Green Identifying number of TMP ▶ 458-00-0327

Address of designated TMP ▶ 4340 Holmes Parkway, Metro City, OH 43704

**Schedule K Shareholders' Shares of Income, Credits, Deductions, etc.**

		(a) Pro rata share items	(b) Total amount		
Income (Loss)	1	Ordinary income (loss) from trade or business activities (page 1, line 21)	1	119,000	
	2	Net income (loss) from rental real estate activities (attach Form 8825)	2		
	3a	Gross income from other rental activities	3a		
		b	Expenses from other rental activities (attach schedule)	3b	
			c	Net income (loss) from other rental activities. Subtract line 3b from line 3a	3c
	4	Portfolio income (loss):			
		a	Interest income	4a	4,000
		b	Dividend income	4b	16,000
		c	Royalty income	4c	
		d	Net short-term capital gain (loss) (attach Schedule D (Form 1120S))	4d	
e		Net long-term capital gain (loss) (attach Schedule D (Form 1120S))	4e		
	f	Other portfolio income (loss) (attach schedule)	4f		
	5	Net gain (loss) under section 1231 (other than due to casualty or theft) (attach Form 4797)	5		
	6	Other income (loss) (attach schedule)	6		
Deductions	7	Charitable contributions (attach schedule)	7	24,000	
	8	Section 179 expense deduction (attach Form 4562)	8		
	9	Deductions related to portfolio income (loss) (itemize)	9		
	10	Other deductions (attach schedule)	10		
Investment Interest	11a	Interest expense on investment debts	11a	3,000	
	b	(1) Investment income included on lines 4a, 4b, 4c, and 4f above	11b(1)	20,000	
		(2) Investment expenses included on line 9 above	11b(2)		
Credits	12a	Credit for alcohol used as a fuel (attach Form 6478)	12a		
	b	Low-income housing credit:			
		(1)	From partnerships to which section 42(j)(5) applies for property placed in service before 1990	12b(1)	
		(2)	Other than on line 12b(1) for property placed in service before 1990	12b(2)	
		(3)	From partnerships to which section 42(j)(5) applies for property placed in service after 1989	12b(3)	
	(4)	Other than on line 12b(3) for property placed in service after 1989	12b(4)		
	c	Qualified rehabilitation expenditures related to rental real estate activities (attach Form 3468)	12c		
	d	Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities	12d		
e	Credits related to other rental activities	12e			
	13	Other credits	13	6,000	
Adjustments and Tax Preference Items	14a	Depreciation adjustment on property placed in service after 1986	14a		
	b	Adjusted gain or loss	14b		
	c	Depletion (other than oil and gas)	14c		
	d	(1) Gross income from oil, gas, or geothermal properties	14d(1)		
		(2) Deductions allocable to oil, gas, or geothermal properties	14d(2)		
e	Other adjustments and tax preference items (attach schedule)	14e			
Foreign Taxes	15a	Type of income ▶			
	b	Name of foreign country or U.S. possession ▶			
	c	Total gross income from sources outside the United States (attach schedule)	15c		
	d	Total applicable deductions and losses (attach schedule)	15d		
	e	Total foreign taxes (check one): <input type="checkbox"/> Paid <input type="checkbox"/> Accrued	15e		
	f	Reduction in taxes available for credit (attach schedule)	15f		
	g	Other foreign tax information (attach schedule)	15g		
Other	16	Section 59(e)(2) expenditures: a Type ▶			
	b	Amount	16b		
	17	Tax-exempt interest income	17	5,000	
	18	Other tax-exempt income	18		
	19	Nondeductible expenses	19	16,350	
	20	Total property distributions (including cash) other than dividends reported on line 22 below	20	65,000	
	21	Other items and amounts required to be reported separately to shareholders (attach schedule)			
	22	Total dividend distributions paid from accumulated earnings and profits	22		
23	Income (loss). (Required only if Schedule M-1 must be completed.) Combine lines 1 through 6 in column (b). From the result, subtract the sum of lines 7 through 11a, 15e, and 16b.	23	112,000		



Schedule L	Balance Sheets	Beginning of tax year		End of tax year	
		(a)	(b)	(c)	(d)
<b>Assets</b>					
1	Cash		14,700		14,514
2a	Trade notes and accounts receivable	98,400		33,700	
b	Less allowance for bad debts		98,400		33,700
3	Inventories		126,000		298,400
4	U.S. Government obligations				
5	Tax-exempt securities		100,000		100,000
6	Other current assets (attach schedule)		26,300		26,300
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach schedule)		100,000		100,000
10a	Buildings and other depreciable assets	204,700		204,700	
b	Less accumulated depreciation	36,000	168,700	45,580	159,120
11a	Depletable assets				
b	Less accumulated depletion				
12	Land (net of any amortization)		20,000		20,000
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization				
14	Other assets (attach schedule)		14,800		19,300
15	Total assets		668,900		771,334
<b>Liabilities and Shareholders' Equity</b>					
16	Accounts payable		28,500		34,814
17	Mortgages, notes, bonds payable in less than 1 year		4,300		4,300
18	Other current liabilities (attach schedule)		6,800		7,400
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more		161,300		215,530
21	Other liabilities (attach schedule)				
22	Capital stock		2,000		2,000
23	Paid-in or capital surplus		198,000		198,000
24	Retained earnings		268,000		309,270
25	Less cost of treasury stock		( )		( )
26	Total liabilities and shareholders' equity		668,900		771,334

**Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return** (You are not required to complete this schedule if the total assets on line 15, column (d), of Schedule L are less than \$25,000.)

1	Net income (loss) per books	106,270	5	Income recorded on books this year not included on Schedule K, lines 1 through 6 (itemize):	
2	Income included on Schedule K, lines 1 through 6, not recorded on books this year (itemize):	0	a	Tax-exempt interest \$ 5,000	5,000
3	Expenses recorded on books this year not included on Schedule K, lines 1 through 11a, 15e, and 16b (itemize):		6	Deductions included on Schedule K, lines 1 through 11a, 15e, and 16b, not charged against book income this year (itemize):	
a	Depreciation \$		a	Depreciation \$ 5,620	5,620
b	Travel and entertainment \$				
	<i>Itemized statement attached</i>	16,350	7	Add lines 5 and 6	10,620
4	Add lines 1 through 3	122,620	8	Income (loss) (Schedule K, line 23). Line 4 less line 7	112,000

**Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed** (see page 22 of the instructions)

	(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1	Balance at beginning of tax year	0	
2	Ordinary income from page 1, line 21	119,000	
3	Other additions	20,000	5,000
4	Loss from page 1, line 21	( 0 )	
5	Other reductions	( 42,500 )	( 850 )
6	Combine lines 1 through 5	96,500	4,150
7	Distributions other than dividend distributions	65,000	0
8	Balance at end of tax year. Subtract line 7 from line 6	31,500	4,150

**SCHEDULE K-1**  
**(Form 1120S)**

**Shareholder's Share of Income, Credits, Deductions, etc.**

OMB No. 1545-0130

▶ See separate instructions.

For calendar year 1995 or tax year  
1995, and ending

**1995**

Department of the Treasury  
Internal Revenue Service

beginning

, 19

Shareholder's identifying number ▶ **458-00-0227**

Corporation's identifying number ▶ **10 448 7965**

Shareholder's name, address, and ZIP code

**John H. Green**  
**4340 Holmes Parkway**  
**Metro City, OH 43704**

Corporation's name, address, and ZIP code

**Strato Tech, Inc.**  
**482 Winston Street**  
**Metro City, OH 43705**

- A** Shareholder's percentage of stock ownership for tax year (see Instructions for Schedule K-1) . . . ▶ **45 %**
- B** Internal Revenue Service Center where corporation filed its return ▶ **Cincinnati, OH**
- C** Tax shelter registration number (see Instructions for Schedule K-1) . . . ▶
- D** Check applicable boxes: (1)  Final K-1 (2)  Amended K-1

		(a) Pro rata share items	(b) Amount	(c) Form 1040 filers enter the amount in column (b) on:
<b>Income (Loss)</b>	<b>1</b>	Ordinary income (loss) from trade or business activities . . . . .	<b>53,550</b>	See pages 4 and 5 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).  Sch. B, Part I, line 1 Sch. B, Part II, line 5 Sch. E, Part I, line 4 Sch. D, line 5, col. (f) or (g) Sch. D, line 13, col. (f) or (g) (Enter on applicable line of your return.) See Shareholder's Instructions for Schedule K-1 (Form 1120S). (Enter on applicable line of your return.)
	<b>2</b>	Net income (loss) from rental real estate activities . . . . .		
	<b>3</b>	Net income (loss) from other rental activities . . . . .		
	<b>4</b>	Portfolio income (loss):		
	<b>4a</b>	a Interest . . . . .	<b>1,800</b>	
	<b>4b</b>	b Dividends . . . . .	<b>7,200</b>	
	<b>4c</b>	c Royalties . . . . .		
	<b>4d</b>	d Net short-term capital gain (loss) . . . . .		
	<b>4e</b>	e Net long-term capital gain (loss) . . . . .		
	<b>4f</b>	f Other portfolio income (loss) (attach schedule) . . . . .		
	<b>5</b>	Net gain (loss) under section 1231 (other than due to casualty or theft) . . . . .		
	<b>6</b>	Other income (loss) (attach schedule) . . . . .		
<b>Deductions</b>	<b>7</b>	Charitable contributions (attach schedule) . . . . .	<b>10,800</b>	Sch. A, line 15 or 16 See page 6 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
	<b>8</b>	Section 179 expense deduction . . . . .		
	<b>9</b>	Deductions related to portfolio income (loss) (attach schedule) . . . . .		
	<b>10</b>	Other deductions (attach schedule) . . . . .		
<b>Investment Interest</b>	<b>11a</b>	Interest expense on investment debts . . . . .	<b>4350</b>	Form 4952, line 1 See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	<b>b(1)</b>	(1) Investment income included on lines 4a, 4b, 4c, and 4f above . . . . .	<b>9,000</b>	
	<b>b(2)</b>	(2) Investment expenses included on line 9 above . . . . .		
<b>Credits</b>	<b>12a</b>	Credit for alcohol used as fuel . . . . .		Form 6478, line 10  Form 8586, line 5
	<b>b</b>	Low-income housing credit:		
	<b>b(1)</b>	(1) From section 42(j)(5) partnerships for property placed in service before 1990 . . . . .		
	<b>b(2)</b>	(2) Other than on line 12b(1) for property placed in service before 1990 . . . . .		
	<b>b(3)</b>	(3) From section 42(j)(5) partnerships for property placed in service after 1989 . . . . .		
	<b>b(4)</b>	(4) Other than on line 12b(3) for property placed in service after 1989 . . . . .		
	<b>12c</b>	c Qualified rehabilitation expenditures related to rental real estate activities . . . . .		
	<b>12d</b>	d Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities . . . . .		
	<b>12e</b>	e Credits related to other rental activities . . . . .		
	<b>13</b>	Other credits . . . . .	<b>2,700</b>	See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
<b>Adjustments and Tax Preference Items</b>	<b>14a</b>	Depreciation adjustment on property placed in service after 1986 . . . . .		
	<b>14b</b>	b Adjusted gain or loss . . . . .		
	<b>14c</b>	c Depletion (other than oil and gas) . . . . .		
	<b>d(1)</b>	d (1) Gross income from oil, gas, or geothermal properties . . . . .		
	<b>d(2)</b>	(2) Deductions allocable to oil, gas, or geothermal properties . . . . .		
	<b>14e</b>	e Other adjustments and tax preference items (attach schedule) . . . . .		

(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on:	
<b>Foreign Taxes</b>	15a Type of income ▶		Form 1116, Check boxes	
	b Name of foreign country or U.S. possession ▶			
	c Total gross income from sources outside the United States (attach schedule)	15c		Form 1116, Part I
	d Total applicable deductions and losses (attach schedule)	15d		
	e Total foreign taxes (check one): <input type="checkbox"/> Paid <input type="checkbox"/> Accrued	15e		Form 1116, Part II
	f Reduction in taxes available for credit (attach schedule)	15f		Form 1116, Part III
	g Other foreign tax information (attach schedule)	15g		See Instructions for Form 1116
<b>Other</b>	16 Section 59(e)(2) expenditures: a Type ▶		See Shareholder's Instructions for Schedule K-1 (Form 1120S).	
	b Amount	16b		
	17 Tax-exempt interest income	17	2,250	Form 1040, line 8b
	18 Other tax-exempt income	18		
	19 Nondeductible expenses	19	7,358	See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
	20 Property distributions (including cash) other than dividend distributions reported to you on Form 1099-DIV	20	29,250	
	21 Amount of loan repayments for "Loans From Shareholders"	21		
22 Recapture of low-income housing credit:			Form 8611, line 8	
a From section 42(j)(5) partnerships	22a			
b Other than on line 22a	22b			
<b>Supplemental Information</b>	23 Supplemental information required to be reported separately to each shareholder (attach additional schedules if more space is needed):			
	.....			
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