

# 19 S Corporations

The 5-year holding period is now permanent.

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## Filing Requirements

**Form 1120S.** All corporations are required to file a return regardless of the amount of income or deductions. A corporation that was an S corporation at any time during the tax year must file Form 1120S for the period of S corporation status.

## Electronic Filing

Corporations can generally e-file Form 1120S with related forms, schedules, and attachments, as well as extensions, employment tax, and other information returns. Requirements and exceptions for e-filing S corporations are generally the same as for C corporations. See *Electronic Filing*, page 18-2.

## ■ New for 2015 ■

- **Increased penalty.** The penalty for failure to furnish Schedule K-1 to a shareholder when due has increased from \$100 to \$250 for each failure. See *Penalties*, page 19-2.
- **Built-in gains tax.** The 5-year holding period for avoiding built-in gains tax on S corporation property has reverted back to 10 years. See *Built-In Gains (BIG) Tax*, page 19-12.

## Common Elections

- Election to be taxed as an S corporation, page 19-4.
- Election to close books on date of S corporation election termination, page 19-6.
- Election to switch order of basis adjustments, page 19-8.
- Election to distribute earnings and profits first, page 19-10.

## S Corporation Advantages/Disadvantages

### Advantages

Liability protection	An S corporation can be set up under state law with the same liability protection as a regular C corporation.
Pass-through taxation	An S corporation does not pay tax at the entity level. Income, loss, and deductions pass through to the shareholder. Corporate-level tax is avoided, eliminating the double tax of a C corporation.
Net operating losses	If net operating losses are anticipated, electing to be taxed as an S corporation will allow the losses to pass through and be claimed on the shareholder's tax return.
No self-employment tax on S corporation income	An employee-shareholder is paid as any other employee with taxes withheld from payroll. However, net income passing through from an S corporation is not subject to payroll or self-employment tax. A reasonable wage must be paid to employee-shareholders. See <i>Reasonable Compensation</i> , page 19-13.

### Disadvantages

One-class-of-stock rule	An S corporation may have only one class of stock. All shareholders must have equal rights to distributions. Special allocations are not allowed. Some loans can violate the one-class-of-stock rule and cause termination of the S election. See <i>One-Class-of-Stock Rule</i> , page 19-3.
Loan basis	An S corporation shareholder's basis does not increase by assuming liability on a loan unless it is a direct loan to the S corporation. See <i>Loans</i> , page 19-8.
Carryovers	Items such as net operating losses from C corporations are not allowed to be used in an S corporation. See <i>No Carryovers Between C and S Year</i> , page 19-14.
All income distributed	In a C corporation, there may be an opportunity to hold profits until a time when the shareholder is in a lower tax bracket. With an S corporation, income is passed through to the shareholder whether or not distributed.
Fringe benefits	A C corporation can generally offer employee-shareholders the same fringe benefits as other employees. Greater than 2% S corporation shareholders are treated as partners for purposes of fringe benefits, and many fringe benefits are not available. See <i>Employee Fringe Benefits</i> , Tab 13, <i>1040 Edition/Deluxe Edition</i> .

Also see the *Business Entity Comparison Chart*, Tab 31, *Small Business Edition*.

## Business Activity Codes

See *Principal Business Activity Codes for Corporations and Partnerships*, page 24-2.

**Note:** The IRS periodically revises these tables to reflect updates to the North American Industry Classification System (NAICS).

## Filing Deadline

Form 1120S is due by the 15th day of the third month following the end of the corporation's tax year, which is March 15 for calendar year corporations. If the S corporation election was terminated during the tax year, and the corporation reverted to a C corporation, file Form 1120S for the S corporation's short year by the due date (including extensions) of the C corporation's short year return.

**Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc.** The corporation is required to provide Schedule K-1 to each shareholder on or before the day on which the corporate return is required to be filed.

**Extensions.** A request for an extension of up to six months is available by filing Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns*. File Form 7004 at the applicable IRS service center for the business by the regular due date of the return. See *Where to File Business Returns*, page 25-1.

## Penalties

**Late filing.** For returns on which no tax is due, the penalty for late filing of an S corporation return is \$195 per month times the number of shareholders, up to 12 months. If any S corporation taxes are due, the penalty is the amount stated above, plus 5% of the unpaid tax for each month or part of a month, up to a maximum of 25% of the unpaid tax. The minimum penalty for a return that is more than 60 days late is the smaller of the tax due or \$135.

**Late payment.** If any S corporation taxes are due, a late payment penalty of half of 1% of unpaid tax per month, or part of a month, applies up to a maximum of 25% of the unpaid tax.

**Schedule K-1.** A \$250 penalty applies for each failure to timely issue Schedule K-1 to a shareholder or failure to provide required information. The penalty may be increased if the failure to provide the schedule is intentional.

The penalties listed above may be waived for reasonable cause.

## Amended Form 1120S

File an amended S corporation tax return using Form 1120S. Check "Amended return" on item (4), line H on page 1 of the return. Attach a statement identifying the line number of each amended item, along with an explanation of the change. If the amended return causes a change in items affecting any shareholder, issue a corrected Schedule K-1 to the affected shareholder with the "Amended K-1" box checked.

## Taxation Summary—Corporations and Partnerships

	S Corporation	C Corporation	Partnership
Taxation	Income and deductions are passed through to shareholders, avoiding corporate-level tax. An S corporation generally does not pay income tax at the entity level.	Income is taxed at the corporate level. Profits are distributed to shareholders as taxable dividends, creating "double tax."	Income and deductions are passed through to partners. A partnership does not pay income tax at the entity level.
Income	Business income from an S corporation is passed through to shareholders and taxed as ordinary income.	After-tax profits of a C corporation are distributed to shareholders as dividends. Qualified dividends are generally taxed to the individual shareholder at long-term capital gain rates (0%, 15%, or 20%).	Income from a partnership is passed through to shareholders and taxed as ordinary income. Guaranteed payments and general partners' share of income is subject to self-employment tax at the individual level.
Losses	Business losses passing through to an S corporation shareholder are treated as ordinary losses.	A C corporation does not pass losses through to shareholders. NOLs may be carried back two years and forward 20 years.	Business losses passing through to partners are treated as ordinary losses.
Capital Gains and Losses	Capital gains and losses pass through to shareholders as separately stated items on Schedule K-1, Form 1120S.	Capital gains earned by a C corporation are taxable to the corporation at the same rate as ordinary income. Losses are not passed through to shareholders.	Capital gains and losses pass through to shareholders as separately stated items on Schedule K-1, Form 1065.

Also see the *Business Entity Comparison Chart*, Tab 31, *Small Business Edition*.

## Basics of S Corporations

### Cross References

- Form 1120S, *U.S. Income Tax Return for an S Corporation*
- IRC Subchapter S, §1361 through IRC §1379

### Related Topics

- Business Deductions, Tab 8, *1040 Edition/Deluxe Edition*
- C Corporations, Tab 18
- Entity Classification Election, page 18-14
- Business Agreements, page 24-1
- Principal Business Activity Codes, page 24-2



### S Corporation Formation

An S corporation is formed in the same manner as any other business corporation. A corporation may be formed under state law, or an eligible non-corporate entity may elect to be taxed as a corporation. Whether the entity formed under state law, or made the election to be taxed as a corporation, the entity must file Form 2553, *Election by a Small Business Corporation*, to elect S corporation status. See *Form 2553, Election by a Small Business Corporation*, page 19-4.

An S corporation provides the same limited liability as a C corporation. However, an S corporation generally does not pay tax at the corporate level, instead passing income through to shareholders in a manner similar to a partnership. Ordinary business income and loss are computed on Form 1120S, *U.S. Income Tax Return for an S Corporation*, and passed through to shareholders, along with other tax items on Schedule K-1 (Form 1120S).



**Did You Know?** The not-for-profit activity limitation of IRC section 183 applies to S corporations. See *Hobby Loss Rules*, page 5-19, *1040 Edition/Deluxe Edition*.

## S Corporation Qualifications

To qualify for S corporation status, the corporation must meet the following requirements.

- An S corporation is limited to 100 shareholders. For this purpose, members of a family are treated as one shareholder. This includes family members up to six generations. A family is defined as the common ancestor, the lineal descendants of the common ancestor, and the spouse (or former spouses) of the lineal descendants or the common ancestor.
- All shareholders are required to consent to the election to be taxed as an S corporation.
- The S corporation can have only one class of stock. See *One-Class-of-Stock Rule*, next column.
- The corporation must be a domestic corporation. Individual shareholders must be citizens or residents of the United States.



Eligible Shareholders	Ineligible Shareholders
Individuals—U.S. citizens or residents	Corporations
Decedent's estates	Partnerships
Bankruptcy estates	Charitable remainder trusts
IRC §501(c)(3) charitable organizations	IRAs
Qualified Subchapter S Trusts (QSSTs)	Simplified employee pensions
Electing Small Business Trusts (ESBTs)	SIMPLE plans
Employee stock option plans	State and local governments
Qualified pension plans	Single-member LLCs (if the LLC has elected to be taxed as a corporation)
Qualified profit sharing plans	

**Qualified Subchapter S Trust (QSST).** A QSST is permitted to hold stock in an S corporation [IRC §1361(d)(3)]. Qualifications include:

- The trust may have only one income beneficiary. If the beneficiary dies, the trust may continue with a successor beneficiary.
- Any corpus distributed during the life of the current income beneficiary may be distributed only to that beneficiary.
- The income interest must terminate on the earlier of the beneficiary's death or termination of the trust.
- Upon the termination of the trust during the life of the current income beneficiary, the trust must distribute all its assets to the beneficiary.
- All accounting income must be distributed (or be required to be distributed) to the single beneficiary during the year.

**Electing Small Business Trust (ESBT).** An ESBT is permitted to hold stock in an S corporation [IRC §1361(e)]. Qualifications include:

- Beneficiaries are limited to individuals, estates, or eligible charities.
- An interest in the trust must have been acquired by gift, bequest, or inheritance. The interest may not be purchased.
- The trustee must file an election under IRC section 1361(e)(3). See Treasury Decision 8994 for information about how to make the election.
- "Potential current beneficiaries" must also be qualified shareholders. Potential current beneficiaries include any person who is entitled to, or may receive a distribution from, the principal or income of the trust. [IRC §1361(e)(2)]

**Qualified Subchapter S Subsidiary (QSub).** A QSub is an S corporation (or a corporation that is eligible to be an S corporation) that is owned 100% by another S corporation.

Although a QSub is disregarded for income tax purposes and does not file a separate return, it is treated as a separate corporation for certain purposes such as federal employment taxes

and information return filing requirements. [Reg. §1.1361-4(a)(7) and (9)]

If the QSub is created through an acquisition, the transaction is treated as a liquidation of the subsidiary. See *Corporate Liquidations*, page 18-19, for more information about liquidations.

**QSub election.** File Form 8869, *Qualified Subchapter S Subsidiary Election*, with the IRS Service Center where the subsidiary filed its most recent return. However, if the parent S corporation forms a subsidiary and makes a valid election effective upon formation, submit Form 8869 to the service center where the parent S corporation filed its most recent return.

The parent S corporation can make the QSub election at any time during the tax year. However, the requested effective date of the QSub election generally cannot be more than:

- Twelve months after the date the election is filed, or
- Two months and 15 days before the date the election is filed.

**Sale of QSub stock.** If the parent S corporation sells any stock of the QSub, the QSub status terminates, and the parent is treated as acquiring the remaining stock of the former QSub in exchange for its assets.

Gain on the sale of QSub stock is proportionate to the percentage of stock sold.

**Example:** Real Joy (RJ) S corporation owns 100% of the stock of Purple Raisins (PR) S corporation. On January 10, 2015, RJ sells 35% of PR's stock to Better Iridescent corporation. PR terminates as a QSub. RJ pays tax on the gain from the sale of 35% of PR's stock.

**Grantor trust.** A grantor trust owned by a U.S. citizen or resident is an eligible shareholder. If the grantor dies, the trust is allowed to continue for 60 days, or two years, if the assets of the trust are includable in the estate of the grantor.

**Testamentary trust.** A testamentary trust may hold S corporation stock if the stock is transferred by a will. The trust is allowed to continue for two years after transfer of the stock.

**Court Case:** A corporation elected S status and had as its sole shareholder a custodial Roth IRA for the benefit of the taxpayer. The corporation contended that a custodial IRA qualified to be an S corporation shareholder because IRS regulations provide that the beneficiary (the taxpayer) of a custodial account should be considered the shareholder. The court held that the Roth IRA was an ineligible shareholder and that the corporation should be taxed as a C corporation; however, four judges issued a dissenting opinion. (*Taproot Administrative Services, Inc.*, 133 T.C. No. 9)

## Ineligible Corporations

The following corporations are not allowed to elect S status. [IRC §1361(b)(2)]

- A financial institution that uses the reserve method of accounting for bad debts.
- Insurance companies.
- A corporation that elects to be treated as a possessions corporation under IRC section 936.
- A Domestic International Sales Corporation (DISC) or former DISC.



## One-Class-of-Stock Rule

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 confer identical rights to distributions and liquidation proceeds. Differences in voting rights are disregarded in determining whether a corporation has more than one class of stock. The determination of whether stock confers identical rights is based

on the corporation's governing provisions, which are defined in regulations as the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements. [Reg. §1.1361-1(l)]

**Court Case:** S corporation shareholders had an agreement to pay unequal distributions to a retired shareholder. The shareholders had been advised that the agreement created a second class of stock negating the S corporation status and had filed all subsequent tax returns on that basis. The Tax Court held that since there was no evidence the shareholders had taken any formal corporate action to implement the understanding, it was nothing more than an informal, oral agreement and did not constitute a second class of stock. The court quoted Regulation section 1.1361-1(l) stating the corporation is treated as having only one class of stock if all the outstanding shares confer identical rights to distribution and liquidation proceeds. Conflicting evidence from the shareholders regarding the purpose of the distributions raised the possibility that the distributions may have constituted proportionate distributions fully consistent with the continued existence of one class of stock. (*Minton, T.C. Memo 2007-372*)

**Author's Comment:** Any time distributions are made to shareholders, each shareholder should receive a distribution in proportion to the percentage of stock owned. Distributions that differ in timing or amount, depending on the facts and circumstances, may be deemed to create a second class of stock and terminate the S corporation status.

**Loans as a second class of stock.** Instruments, obligations, or arrangements, regardless of whether designated as debt, will be treated as a second class of stock if both of the following are true. [Reg. §1.1361-1(l)(4)(ii)(A)]

- The instrument, obligation, or arrangement constitutes equity or otherwise results in the holder being treated as the owner of stock, and
- A principal purpose of issuing or entering into the instrument, obligation, or arrangement is to avoid the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to avoid the limitation on eligible shareholders.

**Straight debt safe harbor.** Straight debt will not be treated as a second class of stock if all of the following are true.

[Reg. §1.1361-1(l)(5)]

- There is a written unconditional promise to pay a certain sum on demand or on a specified date,
- The interest rate is not contingent on profits, the borrower's discretion, or similar factors,
- The debt may not be converted into stock,
- The creditor is an eligible stockholder or a person regularly engaged in the business of lending money,
- Unwritten advances are treated as debt and do not total more than \$10,000 at any time during the year, and
- Obligations owned solely by the shareholders in the same proportion as their outstanding stock are not treated as a second class of stock. [Reg. §1.1361-1(l)(4)(ii)(B)]

**Planning Tip:** The one-class-of-stock rule can be a trap for an S corporation. A number of events can occur that may create a second class of stock, which will invalidate S corporation status. For example, if a shareholder makes a loan to the corporation, and in turn the shareholder receives an increased share of income or profits, the transaction could be considered a second class of stock and S status may be in jeopardy. Loans between the shareholders and the corporation should be closely monitored to avoid violating this rule.

Also, a single ineligible shareholder will terminate S corporation status. The corporation should control all stock transfers so that one shareholder cannot transfer any shares to an ineligible shareholder, whether or not intentional. The corporation should control stock transfers with shareholder agreements, such as right of first refusal.



## Form 2553, Election by a Small Business Corporation

Form 2553 is filed by a corporation to elect to be taxed as an S corporation. The due date for the election is the 15th day of the third month of the tax year the election is to take effect (March 15 for a calendar year corporation). The election may also be filed at any time during the tax year prior to the year the S corporation election is to apply.

An eligible non-corporate entity that files Form 2553 is deemed to have made an election to be taxed as a corporation. This eliminates the need for the entity to file Form 8832, *Entity Classification Election*, in order to choose S corporation taxation. See *Entity Classification Election*, page 18-14, for more information about entities eligible to elect to be taxed as corporations.

**Shareholder consent.** All shareholders must consent to an S corporation election. Shareholder information required on Form 2553 includes the name, address, taxpayer ID number, information about stock ownership, and taxable year of the shareholder. Once an election is in place, a new shareholder joining the corporation does not need to make a formal consent.

## Relief for Late S Corporation Elections

Revenue Procedure 2013-30 simplifies the granting of relief to late-filing entities by consolidating numerous other revenue procedures into one procedure and by extending relief in certain circumstances. This procedure provides guidance for relief for late:

- S corporation elections,
- Electing Small Business Trust (ESBT) elections,
- Qualified Subchapter S Trust (QSST) elections,
- Qualified Subchapter S Subsidiary (QSub) elections, and
- Corporate classification elections which the entity intended to take effect on the same date that the S corporation election would take effect.

**Three years and 75 days rule (due date for relief).** Relief under Revenue Procedure 2013-30 must be requested within three years and 75 days after the effective date of the intended election. See *Exception to three years and 75 days rule*, page 19-5.

**General relief rules for S corporation elections.** Relief under Revenue Procedure 2013-30 is granted when all of the following requirements are met.

- The entity intended to be classified as an S corporation, is an eligible entity, and failed to qualify solely because the election was not timely filed,
- The entity has reasonable cause for its failure to make the election timely,
- The entity and all shareholders reported their income consistent with an S corporation status for the year the election should have been made and all subsequent years, and
- Less than three years and 75 days have passed since the intended effective date of the election. See *Exception to three years and 75 days rule*, page 19-5.



If an entity does not qualify for relief under Revenue Procedure 2013-30, it may still request relief by requesting a private letter ruling. The procedure for requesting a letter ruling and the associated fees are described in Revenue Procedure 2015-1, or its successor.

**Procedure for relief.** For relief under Revenue Procedure 2013-30, complete the following procedures.

**Form 2553.** A completed Form 2553 must:

- Be signed by an officer authorized to sign,
- Be signed by all persons who were shareholders at any time during the period the election was intended to be effective and ending the day the completed election is filed,

- Include statements from all shareholders during the above period that they have reported their income on all affected returns consistent with S corporation status for the year the election should have been made, and for all subsequent years,
- Include a statement from the corporation describing its reasonable cause for failure to timely file the election and its diligent actions to correct the mistake upon discovery,
- Each supporting statement must contain a dated declaration that states, “Under penalties of perjury, I(we) declare that I (we) have examined this election, including accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete.” An officer of the corporation authorized to sign or a shareholder, as applicable, must sign the declaration, and
- Form 2553 must state at the top “FILED PURSUANT TO REV. PROC. 2013-30.”

**Filing.** The corporation must file Form 2553 by either:

- Attaching the election to the current year Form 1120S as long as the current year Form 1120S is filed within the three years and 75 days rule. An extension of time to file Form 1120S will not extend the due date for relief. Form 1120S must state at the top “INCLUDES LATE ELECTION(S) FILED PURSUANT TO REV. PROC. 2013-30.”
- Attaching the election to one of the S corporation’s late filed prior year Forms 1120S as long as the form is filed within the three years and 75 days rule and all other delinquent Forms 1120S are filed simultaneously and consistent with the requested relief. Form 1120S must state at the top “INCLUDES LATE ELECTION(S) FILED PURSUANT TO REV. PROC. 2013-30.”
- File Form 2553 independent of Form 1120S by submitting directly to the applicable IRS service center within the three years and 75 days rule.

See *Three years and 75 days rule (due date for relief)*, page 19-4.

**Additional materials for late corporate classification election intended at same time as S corporation election.** In the case of a late corporate classification election intended to be effective on the same date that the S corporation election was intended to be effective, Form 2553 must also include the following representations, accompanied by signed perjury statements, above.

- The requesting entity is an eligible entity defined in Regulation section 301.7701-3(a),
- The requesting entity intended to be classified as a corporation as of the effective date of the S corporation status,
- The requesting entity fails to qualify as a corporation solely because Form 8832, *Entity Classification Election*, was not timely filed,
- The requesting entity fails to qualify as a S corporation solely because Form 2553 was not timely filed, and
- The requesting entity timely filed all required federal tax returns and information returns consistent with S corporation status for all years the entity intended to be an S corporation or has not filed because the due date has not yet passed.

**Exception to three years and 75 days rule.** Entities meeting all of the following conditions are not limited by the three years and 75 days rule.

- The entity is a corporation (not an LLC seeking an entity classification election),
- The corporation failed to qualify solely because the election was not timely filed,
- The corporation and all its shareholders reported their income consistent with S corporation status for the year the election should have been made and all subsequent years,
- At least six months have elapsed since the date on which the corporation filed its tax return for the first year it intended to be an S corporation,

- Neither the corporation nor any of its shareholders was notified by the IRS of any problems regarding the S corporation status within six months of the date on which Form 1120S for the first year was timely filed, and
- The completed Form 2553 includes all the statements as described in Revenue Procedure 2013-30.

## Termination of S Corporation Status

### Cross References

- Form 1120S, *U.S. Income Tax Return for an S Corporation*
- IRC §1362(d), *Termination*

### Related Topics

- Corporate Liquidations, page 18-19
- Sale of a Business, Tab 27, *Small Business Edition*



### Termination

An S corporation election will terminate, and the corporation will revert to C corporation taxation, upon the occurrence of any one of the following events.

- Shareholders revoke the election,
- The corporation fails to qualify as an S corporation, or
- The corporation violates the passive income restrictions (for corporations with earnings and profits).

**Shareholder revocation.** The S corporation election may be revoked with the consent of shareholders holding more than 50% of the shares of stock of the corporation. A revocation made on or before the 15th day of the third month of the taxable year is effective as of the first day of the taxable year (March 15 for a calendar year corporation).

Revocation made after the 15th day of the third month of the tax year is effective for the following taxable year.

Revocation can be made for a prospective date which is on or after the date the revocation is made. [IRC §1362(d)(1)]

**Corporation statement.** The corporation files a statement of revocation, signed by an officer who is authorized to sign Form 1120S, with the IRS Service Center where the original election was filed. Include the following information.

- A statement that the corporation is revoking its S corporation election under IRC section 1362(a).
- The corporation’s name, address, and EIN.
- The number of shares of outstanding stock.
- The effective date of the revocation.
- The shareholder’s consent statements.



**Shareholder statement.** A statement signed by the shareholder, under penalty of perjury, which includes:

- The name, address, and EIN of the consenting shareholder.
- The number of shares owned by the shareholder.
- The date the shareholder acquired the stock.
- The shareholder’s tax year end.
- The name and EIN of the S corporation.
- The election to which the shareholder consents.

The shareholder’s consent statement should be attached to the corporation’s election revocation statement.

**Passive investment violation.** An S corporation election shall terminate if passive investment income exceeds 25% of gross receipts for three consecutive taxable years, and the corporation has accumulated earnings and profits from periods when the corporation was a C corporation. The termination will occur on the first day of the taxable year after the three-year period. [IRC §1362(d)(3)]

For purposes of this provision, passive income includes income from royalties, rents, dividends, interest, and annuities. Rents does not include rents derived in the active trade or business of renting property. Rents received are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. [Reg. §1.1362-2(c)(5)] See *Excess Net Passive Income Tax*, page 19-11.

➤ **Planning Tip:** An S corporation that earns passive income and has accumulated earning and profits may want to consider making a dividend distribution sufficient to eliminate the accumulated E&P. This would avoid possible termination due to passive income restrictions and also avoid the possible tax on excess net passive income. See also *Deemed Dividends*, page 19-11.

### Inadvertent Termination

If an inadvertent S corporation termination occurs, and the corporation takes steps to correct the terminating event within a reasonable time after discovery, the IRS may allow the corporation to continue to operate as an S corporation. The corporation has the burden of establishing that the termination was inadvertent. A termination may be found to be inadvertent if the event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the event took place without the knowledge of the corporation. Permission from the IRS is required to disregard an inadvertent termination. (Reg. §1.1362-4)

### Five-Year Waiting Period for Reinstatement

If an S corporation election is terminated, whether by shareholder revocation, ceasing to qualify, or violating the passive income restrictions, a five-year waiting period applies during which the corporation cannot re-elect S corporation status without IRS consent. [IRC §1362(g)]

### Treatment of S Corporation Termination Year

Termination of an S corporation election will create two short tax years. Income, loss, deductions, and credits are allocated between the S and C corporation short years on a pro-rata basis using the number of days in each short year.

**Exception:** If there is a sale or exchange of 50% or more of the stock in the corporation during the year the S corporation terminates, the pro-rata allocation method may not be used. See *Election to close books*, below.

**Example #1:** Card Corporation, a calendar year corporation, starts out the year with a valid S corporation election in place. On May 1, the corporation's S status terminates. The pro-rata allocation will be 33% to the S corporation, and 67% to the C corporation (120 days ÷ 365 days = 33%; 245 days ÷ 365 days = 67%). Card corporation has income of \$120,000 for the full year. The income is allocated as follows:

S corporation at 33% = \$ 39,600 (\$120,000 × 33%)  
 C corporation at 67% = \$ 80,400 (\$120,000 × 67%)  
 Income..... \$120,000



**Election to close books.** An S corporation may elect to close the books on the date of termination upon consent of all the shareholders. An election to close the books will allocate income, loss, deductions, and credits during the S corporation short year to the S corporation and C corporation items to the C corporation short year. [Reg. §1.1362-3(b)]

**Note:** If there was a sale or exchange of 50% or more of the stock of the corporation during the year the S corporation was terminated, this method is mandatory and the pro-rata allocation cannot be used.

**Example #2:** Assume the same information as Example #1, except with the additional information that \$100,000 was earned before the S corporation termination occurred, and the remaining \$20,000 was earned after the termination. Card Corporation's shareholders made an election to close the books. Therefore, \$100,000 will be allocated to the S corporation, and \$20,000 will be allocated to the C corporation.

## Flow-Through to S Corporation Shareholders

### Cross References

- Form 1120S, *U.S. Income Tax Return for an S Corporation*
- IRC §1366, *Pass-thru of items to shareholders*



### Related Topics

- Self-employed health insurance deduction, page 5-9, *1040 Edition/Deluxe Edition*
- Passive Activity Losses, page 7-9, *1040 Edition/Deluxe Edition*
- At-Risk Rules, page 7-14, *1040 Edition/Deluxe Edition*
- Business Deductions, Tab 8, *1040 Edition/Deluxe Edition*
- Retirement and Employee Benefits, Tab 13, *1040 Edition/Deluxe Edition*

### Ordinary Business Income

Ordinary business income or loss for an S corporation is netted and reported on line 21, page 1, Form 1120S. The ordinary income or loss is then allocated to shareholders based on their percentage of stock ownership. The income or loss is passed through to shareholders on Schedule K-1 (Form 1120S), and the amounts are reported on the shareholders' income tax returns.

Net ordinary business income from an S corporation is reported to shareholders on a pro-rata basis. Other items pass through to shareholders as separately stated items. See *Separately Stated Items*, page 19-7.

### Pro-Rata Allocation/Per-Share/Per-Day

Items are passed through to shareholders according to their percentage of ownership based on a per-share/per-day method. If there was no change in ownership during the year, the percentage of stock owned is used to determine the amount passed through. If a change of ownership occurred, each shareholder's percentage is weighted for the number of days the stock was held.

*Allocation formula:*

$$\text{Percentage of stock owned} \times \text{Percentage of year owned}$$

**Example:** Sam and Dan each owned 50% of S&D, an S corporation, for the first half of 2015. On July 1, Elbert purchased 10% of Sam's stock and 10% of Dan's stock. The three shareholders' pro-rata shares are determined as follows.

	% of stock owned	% of year owned	Pro-rata share
Sam	50%	50%	25%
	40%	50%	20%
			Sam's share 45%
Dan	50%	50%	25%
	40%	50%	20%
			Dan's share 45%
Elbert	20%	50%	Elbert's share 10%

**Election to allocate based on two short years.** The S corporation may elect to allocate items as if the tax year consisted of two taxable years if the following requirements are met.

- A shareholder terminates his or her entire interest during the year, or
- A qualifying disposition took place.

**Termination of shareholder's entire interest.** If a shareholder's entire interest is terminated during the year, the shareholders may elect to allocate income as if the corporation's taxable year consisted of two taxable years, with the first year ending on the day the interest was terminated. All affected shareholders must agree, including the shareholder whose interest was terminated. Once made, the election is irrevocable and is effective only for the terminating event for which it is made.

To make the election, the corporation must attach a statement to a timely filed original or amended Form 1120S for the tax year for which the election is made. The corporation must state that it is electing under IRC section 1377(a)(2) and Regulation section 1.1377-1(b) to treat the tax year as if it consisted of two separate tax years. The statement must also explain how the shareholder's entire interest was terminated (e.g., sale or gift), and state that the corporation and each affected shareholder consents to the election. A single statement may be filed for all terminating elections made for the tax year. Also write "Section 1377(a)(2) Election Made" at the top of each affected shareholder's Schedule K-1.

**Qualifying disposition.** A qualifying disposition is:

- A disposition by a shareholder of 20% or more of the outstanding stock of the corporation in one or more transactions during any 30-day period during the corporation's taxable year, or
- A redemption of 20% or more of the outstanding stock of the corporation from a shareholder in one or more transactions during any 30-day period during the corporation's taxable year, or
- An issuance of an amount of stock equal to or greater than 25% of the previously outstanding stock to one or more new shareholders during any 30-day period during the corporation's taxable year. [Reg. §1.1368-1(g)]

## Separately Stated Items

On Form 1120S, net business income and deductions are computed, and ordinary income or loss is passed through to shareholders according to their pro-rata percentages. The treatment of some items, however, might be subject to limits or other special treatment on the shareholder's return. These items are separately stated on Schedule K-1 (Form 1120S).

Examples of separately stated items include:

- Income or loss from rental real estate.
- Income or loss from other rental activity.
- Interest.
- Dividends.
- Royalties.
- Capital gains and losses.
- IRC section 1231 gains and losses.
- Investment expenses.
- Charitable contributions.
- Section 179 expenses.
- Tax preferences and adjustments for AMT computations.
- Nonbusiness bad debts.



**Disposal of Section 179 property.** If the S corporation disposes of property for which Section 179 was ever taken, special rules apply. See *Special disclosure for certain disposals of business property*, Tab 20.

**Character of income.** The character of any item passed through from an S corporation to a shareholder is treated as if the shareholder directly realized or incurred the item. For example, a

short-term capital gain passed through from an S corporation to a shareholder must be treated as a short-term capital gain by the shareholder. [IRC §1366(b)]

## Shareholder Basis

### Cross References

- Schedule K-1 (1120S), *Shareholder's Share of Income, Deductions, Credits, etc.*
- IRC §1367, *Adjustments to basis of stock of shareholders, etc.*

### Related Topics

- At-Risk Rules, page 7-14, 1040 Edition/ Deluxe Edition
- S Corporation Shareholder's Adjusted Basis Worksheet, page 24-5



## S Corporation Shareholder's Basis

An S corporation shareholder's basis determines the following:

- The allowance of nontaxable distributions of cash or property, and
- The deductibility of flow-through losses and deductions.

### Key points:

- A nondividend distribution in excess of stock basis is taxed as a capital gain on the shareholder's personal return, usually a long-term capital gain.
- Nondeductible expenses reduce a shareholder's stock and debt basis before loss and deduction items (unless shareholder elects to switch the order, see *Election to switch order of basis adjustments*, page 19-8).
- If nondeductible expenses exceed basis, they do not get carried forward unless the shareholder elects to switch the order, see *Election to switch order of basis adjustments*, page 19-8. If this election is made, the excess expenses retain their character and are carried forward to the succeeding tax year.
- A shareholder is not allowed to claim losses and deductions in excess of stock and debt basis. Losses and deductions not allowable in the current year are suspended due to basis limitations and are carried over to subsequent years.
- Suspended losses and deductions due to basis limitations retain their character in subsequent years.
- A shareholder is allowed debt basis only to the extent he or she has personally lent money to the S corporation. A loan guarantee is not sufficient to allow the shareholder debt basis.
- If an S corporation repays reduced basis debt to a shareholder, part or all of the repayment is taxable to the shareholder. See *Repayment of reduced basis debt*, page 19-9.
- If stock is sold, suspended losses due to basis limitations are lost. The sales price does not have an impact on the stock basis.

**Stock basis and loan basis.** Stock basis and loan basis are adjusted and applied separately.

**Note:** Neither basis can go below zero.

All distributions of cash or property and flow-through deductions are applied first against stock basis. If there is sufficient stock basis to absorb the amounts, there is no taxable income to the shareholder, and the losses and deductions are fully allowed on the shareholder's tax return.

**Taxability of distributions—stock basis only.** If a distribution of cash or property exceeds stock basis, the excess is a taxable capital gain. These distributions are taken into consideration before flow-through losses and deductions. See *Order of adjustments in stock basis*, page 19-8.

**Deductibility of flow-through losses and deductions—stock and/or loan basis.** Loan basis is a second tier of basis that can be applied to deduct flow-through losses and deductions if stock basis has been reduced to zero.

**Example:** Bert is 100% shareholder of Writers, Inc., an S corporation. Bert's stock basis is \$3,500. In addition, Bert has a loan basis of \$5,000, which occurred when he made a direct loan to the corporation.

In 2015, Writers Inc. made a cash distribution to Bert in the amount of \$4,000. Since distributions are taken into account before losses and deductions, and loan basis may not be applied to distributions, Bert must recognize a \$500 capital gain on the distribution. The corporation also passed through losses on Schedule K-1 in the amount of \$3,000. Bert can apply the losses against loan basis.

	Stock Basis	Loan Basis
\$4,000 cash distribution (distributions can go against stock basis only—basis cannot go below zero)	\$ 3,500 (3,500) \$ 0	\$5,000
	\$500 gain	
\$3,000 flow-through losses	\$ 0	(3,000)
Ending basis	\$ 0	\$2,000

On Bert's return, he recognizes a \$500 capital gain and deducts a \$3,000 loss. His stock basis is \$0, meaning any further distributions of cash or property will result in a capital gain until stock basis is restored. He has \$2,000 in loan basis remaining, meaning he will be able to deduct up to \$2,000 of future flow-through losses against his loan basis.

See *Basis restorations apply first to loan basis*, page 19-9.

**Author's Comment:** One significant difference between stock basis and loan basis is that tax-free distributions can be taken against stock basis, but not loan basis. If stock basis is zero, and loan basis exists, a distribution should be categorized as a nontaxable repayment of a shareholder loan instead of a distribution.

## S Corporation Shareholder's Basis Adjustments

### Order of Adjustments in Stock Basis

Basis is increased by:	Schedule K-1...
1) Stock purchases and additional capital contributions.	N/A
2) Ordinary income.	Box 1
3) Separately stated income items.	Boxes 2 - 10
4) Tax-exempt income.	Boxes 16A and 16B
5) Excess depletion.	Box 15C
Basis is decreased by:	Schedule K-1...
6) Distributions. <sup>2</sup>	Box 16D
7) Nondeductible expenses. <sup>3,4</sup>	Box 16C and 17R
8) Ordinary loss.	Box 1
9) Separately stated loss items.	Boxes 2 – 120, 14L, and 14M

<sup>1</sup> See *S Corporation K-1 Codes*, page 7-3.

<sup>2</sup> Distributions in excess of stock basis result in taxable capital gain.

<sup>3</sup> See *Election to switch order of basis adjustments*, next column.

<sup>4</sup> Includes the depletion deduction for any oil and gas property held by the corporation, but only to the extent the shareholder's pro-rata share of the property's adjusted basis exceeds that deduction.

**Note:** Stock basis cannot go below zero.

See *S Corporation Shareholder's Adjusted Basis Worksheet*, page 24-5.

See *Basis restorations apply first to loan basis*, page 19-9, for information about whether to apply basis increases to stock basis or loan basis.

**Election to switch order of basis adjustments.** An election is available to reduce an S corporation shareholder's basis by pass-through losses before nondeductible expenses (switching item #7 with #8 and #9 in *Order of Adjustments in Stock Basis*, previous column). This election can result in a higher allowable deduction for the tax year.

This election can also allow excess nondeductible expenses, which would ordinarily be lost, to retain their character and be carried forward. [Reg. §1.1367-1(g)]

**Making the election.** A shareholder makes the election by attaching a statement to a timely-filed original or amended tax return indicating that the taxpayer agrees to the carryover rule of Regulation section 1.1367-1(g) and the name of the S corporation to which the rule applies. Once made, the election cannot be changed without IRS consent.

**Example:** Lucy is 100% owner of Redcorp, an S corporation. Lucy's basis on December 31, 2014 is \$10,000. There were no distributions in 2015. Redcorp passes through the following items on Schedule K-1.

- Ordinary loss of \$10,000.
- Nondeductible penalties of \$2,500.



The treatment with and without the election to switch order of basis adjustment follows.

Standard Order		Election to Switch Order	
Basis 12/31/14	\$10,000	Basis 12/31/14	\$10,000
Nondeductible items	\$ 2,500	Ordinary loss	\$10,000
Basis subtotal	\$ 7,500	Basis subtotal	\$ 0
Ordinary loss	\$10,000	Nondeductible items	\$ 2,500
Result	Deductible loss of \$7,500, carryover loss of \$2,500, zero basis	Result	Deductible loss of \$10,000, carryover of nondeductible items, zero basis

## Loans

**Direct loans.** An S corporation shareholder's loan basis for purposes of deducting losses will be increased only by a direct loan to the S corporation.

Under IRC section 1366(d)(1)(B), a loan increases basis by "the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder."

Recently finalized regulations provide that, in order to increase a shareholder's basis of indebtedness, a loan must represent bona fide indebtedness of the S corporation that runs directly to the shareholder. The regulations also reaffirm that a shareholder acting as guarantor of S corporation indebtedness does not create or increase his or her basis simply by becoming a guarantor. (TD 9682)

The following tax court ruling illustrates that even when there is a direct loan from the shareholder to the S corporation, basis is not increased when the transaction lacks economic substance.

**Court Case:** The taxpayer took out annual loans from his wholly-owned partnership. In turn, he loaned identical amounts of money to his S corporation. In turn, the S corporation paid equivalent amounts of rent back to the partnership. The court held that the taxpayer did not acquire a basis in indebtedness of the S corporation from the annual loans since the transaction involved a circular flow of funds and, therefore, the taxpayer had no economic outlay. (*Kerzner*, T.C. Memo 2009-76)



**Loan guarantees.** A loan guarantee will not increase an S corporation shareholder's basis for deducting losses. [Reg. §1.1366-2(a)(2)(ii)]

**Note:** This is in contrast to a partnership where a general partner's share of partnership liabilities will increase basis regardless of whether or not a direct loan has been made. The eventual payment of a loan guarantee does not increase an S corporation shareholder's basis for years prior to the loan payment.

**Planning Tip:** Most small corporations will not be able to secure a loan in the corporation's name without a personal guarantee, usually by a shareholder. In order to increase basis for purposes of deducting losses, the shareholder should take out a personal loan, then in turn make a loan directly to the S corporation. Even though the financial effect will generally be the same, and the only difference is some additional paperwork, the direct loan to the S corporation will increase basis, where the loan guarantee will not.

**At-risk basis.** A loan guarantee will increase the shareholder's at-risk basis, but will not increase the basis for purposes of deducting S corporation losses. See *At-Risk Rules*, page 7-14, 1040 Edition/Deluxe Edition.

**Basis restorations apply first to loan basis.** If loan basis has been reduced in prior years, any basis increase from income items must be applied first to restore basis in the loan before being applied to increase stock basis. This applies only to loans that were in place at the beginning of the year. The loan basis is restored up to the loan balance (original loan less repayments).

**Example:** Alan owns 100% of Colmes Corp, an S corporation. In 2014, Colmes Corp passed through losses of \$4,500. There were no distributions of cash or property. Alan's stock basis was \$0, and his loan basis was \$10,000. Alan deducted the losses by applying them against his loan basis, bringing his loan basis to \$5,500 (\$10,000 – \$4,500).

In 2015, Colmes Corp passed through net income of \$6,000. Under the basis restoration rules, the income had to be applied first to restoration of loan basis. Therefore, the loan was restored to \$10,000, and Alan's stock basis was restored by the remainder, \$1,500.

**Repayment of reduced basis debt.** If an S corporation repays reduced basis debt to a shareholder, part or all of the repayment is taxable to the shareholder.

**Court Case:** The taxpayer owned stock in and loaned money to the S corporation. The S corporation incurred losses which reduced the taxpayer's stock basis to zero and his debt basis to \$112,000. The S corporation then distributed \$650,000 to the taxpayer to repay the loan. The taxpayer contributed an amount to the S corporation's capital to offset the distribution. The Tax Court ruled that the capital contribution increased the taxpayer's stock basis, not loan basis. The distribution was taxable because it exceeded the loan's basis. (*Nathel*, 131 T.C. No. 17)

**Open account debt.** When a shareholder makes multiple advances to an S corporation that are not evidenced by separate written instruments, the undocumented loans are treated as a single indebtedness, referred to as "open account debt." If the running balance of open account debt exceeds \$25,000 at the close of the taxable year, the entire principal amount of that indebtedness would be treated as debt evidenced by a written instrument. Any subsequent advances to the S corporation would constitute new open account debt. If the \$25,000 threshold is exceeded, causing open account debt to be treated as evidenced by a separate written instrument, ordering rules and allocations are required in accordance with Regulation section 1.1367-2.

**Ordinary income vs. capital gain.** A shareholder-creditor of an S corporation derives ordinary income from the repayment of a loan made on open account to the extent the repayments exceed the shareholder's basis in the loan. (Rev. Rul. 68-537)

Where a corporation has issued the shareholder a note as an evidence of the indebtedness, such note is a capital asset in the hands of the shareholder. Payments received by the shareholder on retirement of the note constitute gains received from the sale or exchange of a capital asset to the extent they exceed the shareholder's basis in the note. (Rev. Rul. 64-162)

## Charitable Contributions of Appreciated Property by S Corporations

In general, the amount of losses and deductions an S corporation shareholder can claim is limited to the shareholder's adjusted basis in stock and direct loans made by the shareholder to the corporation.

**Exception:** For tax years beginning on or after January 1, 2006 and before January 1, 2015, this basis limitation does not apply to a charitable contribution of appreciated property to the extent the shareholder's pro-rata share of the contribution exceeds the shareholder's pro-rata share of the adjusted basis of the property contributed.

**This exception provision is now permanent.**

**Note:** This exception expired for tax years after 2014. At the time this publication went to print, the provision had not been extended. See *What's New*, Tab 1, for any new information about extension of this provision.



## Basis of S Corporation Stock Upon Conversion From C Corporation

The basis of a C corporation shareholder's stock becomes the beginning basis in stock when the corporation converts to S status. Earnings and profits (E&P) carried over from a C corporation do not add to basis. In some cases, it may be advantageous to distribute E&P before converting to S status. See *Passive investment violation*, page 19-5.

**Example:** Kurt owns 100% of Trumpet, Inc., a C corporation. Trumpet has \$25,000 of undistributed earnings and profits when Kurt converts to S status in 2015. Kurt's basis in the stock of the C corporation was \$7,200 before the conversion. After the conversion, the corporation passes through a loss of \$15,000. Kurt's deductible loss is limited to his basis, which is \$7,200. The remaining \$7,800 in losses carries over and will not be deductible until Kurt increases his stock basis. The loss does not reduce earnings and profits.

If Kurt had taken a deemed dividend of \$7,800, earnings and profits would be reduced without a net taxable effect. The deemed dividend would have been taxable to Kurt, but he would have been able to claim the offsetting loss. See *Deemed Dividends*, page 19-11.

## Discharge of Indebtedness

An S corporation shareholder's basis is generally increased by both taxable and tax-exempt income. However, any income from discharge of indebtedness that is nontaxable does not increase basis. [IRC §108(d)(7)]



# Distributions

## Cross References

- Form 1120S, *U.S. Income Tax Return for an S Corporation*
- IRC §1368, *Distributions*

## Related Topics

- Partnerships and S corporations—Schedule K-1, page 7-4, *1040 Edition/Deluxe Edition*
- Distributions to Shareholders (C corporations), page 18-13

## Acronyms

The following acronyms are commonly used to describe items relating to distributions to S corporation shareholders.

AAA: Accumulated Adjustments Account

OAA: Other Adjustments Account

PTTP: Post Termination Transition Period

E&P: Earnings and Profits



## S Corporations With No Earnings and Profits

All distributions from an S corporation are treated as return of capital if the S corporation has no earnings and profits. An S corporation will generally not have earnings and profits unless the corporation was once a C corporation.

**Amount applied against basis.** Distributions are tax free up to the amount of the shareholder's basis in stock.

**Amount in excess of basis.** If the amount of the distribution exceeds the adjusted basis of the stock, the excess is treated as a capital gain.

Also see *Stock basis and loan basis*, page 19-7.

## S Corporations With Earnings and Profits

A corporation with earnings and profits must maintain an accumulated adjustments account to determine taxability of distributions to shareholders. See *Other Adjustments Account*, next column.

Although keeping an accumulated adjustments account is not required for S corporations with no earnings and profits, it is recommended.

## Accumulated Adjustments Account (AAA)

The accumulated adjustments account represents the accumulation of undistributed S corporation income. Distributions to shareholders are not taxable to the extent of the balance in the accumulated adjustments account.

The taxation of distributions in excess of the accumulated adjustments account depends on whether the corporation has accumulated earnings and profits. See *Ordering Rules*, next column.

**Example:** On January 1, 2014, Shannon formed Chalker, Inc., an S corporation. For tax year 2014, the S corporation passed through income of \$16,000 that Shannon reported on her individual tax return. The income was a positive adjustment to the accumulated adjustments account. Shannon did not receive any distributions in 2014.

In 2015, Shannon took a distribution of \$15,000 from Chalker, Inc. Since the accumulated adjustments account had a balance of \$16,000, the distribution was not taxable to Shannon. The distribution caused a negative adjustment to the accumulated adjustments account, which had a balance of \$1,000 after the distribution.

**Corporate account.** The accumulated adjustments account belongs to the S corporation and does not belong to any specific shareholder. A new shareholder who purchases stock in an S corporation also purchases a share of the accumulated adjustments account and is eligible to receive tax-free distributions.

**Adjustments.** The accumulated adjustments account is adjusted in the same manner as the shareholder's basis, with the following exceptions.

- No adjustment is made for stock purchases or additional capital contributions.
- No adjustment is made for tax-exempt income and expenses.
- The accumulated adjustments account can have a below-zero balance from losses (but not from distributions). The deficit is made up by positive adjustments in future years.

## Other Adjustments Account (OAA)

The other adjustments account is adjusted for tax-exempt income (and related expenses) and federal taxes attributable to a C corporation tax year. See *Ordering Rules*, below.

## Ordering Rules

The following ordering rules apply to S corporation distributions.

Ordering Rules for S Corporation Distributions		
	Tax Effect on Shareholder	Effect on Stock Basis
1) AAA	Not taxable	Negative adjustment
2) E&P	Taxable dividend	No adjustment
3) OAA	Not taxable	Negative adjustment
4) Return of capital	Not taxable up to basis in stock	Negative adjustment
5) Excess of basis in stock	Capital gain	No adjustment

**Example:** Todd is 100% owner of Leftfield, Inc., an S corporation. Leftfield has no accumulated earnings and profits. In 2013, the accumulated adjustments account had a balance of \$12,500. Todd's stock basis was also \$12,500. In 2013, Leftfield, Inc. passed through a loss to Todd in the amount of \$15,000.



In 2014, Leftfield, Inc., made a distribution to Todd of \$3,000 and passed through a loss of \$1,200.

In 2015, Leftfield, Inc. passed through income of \$6,000 to Todd.

	AAA	Stock Basis
Starting basis	\$12,500	\$12,500
Pass through loss \$15,000	(15,000)	(12,500)
Balance 12/31/13	(2,500)	\$0 (stock basis cannot go below zero—\$2,500 suspended loss)
Distribution \$3,000		\$0 (\$3,000 capital gain—distribution in excess of stock basis)
Loss \$1,200	(1,200)	
Balance 12/31/14	(3,700)	\$0 (increases suspended loss to \$3,700)
Pass through income \$6,000	\$6,000	\$6,000
Balance 12/31/15	\$2,300	(3,700)
		\$2,300 (Todd reports the \$6,000 gain and also picks up the \$3,700 suspended loss on his tax return)

## Election to Distribute Earnings and Profits First

An S corporation can elect to alter the ordering rules and distribute earnings and profits first and amounts from the accumulated adjustments account second. [IRC §1368(e)(3)]

The election is irrevocable and applies only for the tax year for which it is made.

## Deemed Dividends

An S corporation may elect to distribute all or part of its C corporation earnings and profits through a deemed dividend. The election is considered to be an election to distribute earnings and profits first. See *Election to Distribute Earnings and Profits First*, above. The amount of the deemed dividend is considered as distributed to the shareholders in proportion to their stock ownership, then immediately contributed by the shareholders back to the corporation, all on the last day of the corporation's taxable year. Shareholders pay tax on a deemed distribution, and the amount increases the basis in stock.

In certain cases, it can be advantageous to declare a deemed dividend if the corporation is low on cash. See the example under *Basis of S Corporation Stock Upon Conversion from C Corporation*, page 19-9.

## Making the Elections

To make the election to distribute earnings and profits first, or the election for deemed dividends, attach a statement to a timely filed original or amended Form 1120S for the tax year for which the election is made. In the statement, the corporation must identify the election it is making and must state that each shareholder consents. The statement of election to make a deemed dividend must include the amount of the deemed dividend distributed to each shareholder. [Reg. §1.1368-1(f)(5)]

## Post Termination Transition Period (PTTP)

When a corporation terminates S corporation status, rules for distributions generally revert to C corporation rules. However, a post termination transition period applies special rules for distributions to be treated as if the distributions were made by an S corporation. For the duration of the post termination transition period, distributions from the accumulated adjustments account and the other adjustments account retain their tax-free character, up to the shareholder's adjusted basis in S corporation stock. (Reg. §1.1377-2)

Also see *Election to Distribute Earnings and Profits First*, above.

**Duration.** The post termination transition period begins the day after termination of S corporation status and ends on the later of:

- The day that is one year after the date of termination, or
- The due date for filing the last S corporation return (including extensions).

## S Corporation Liquidation

Generally, the same rules apply to an S corporation as to a C corporation regarding a corporate liquidation. However, since S corporation pass-through rules still apply, any taxable gain will flow through to the shareholders. The liquidating S corporation will not incur any taxes unless the built-in gains tax applies. See *Corporate Liquidations*, page 18-19.

**Tax consequences to shareholders.** Amounts distributed to a shareholder in complete liquidation of an S corporation are treated as full payment in exchange for stock. The character of any gain or loss recognized will depend on whether the stock is a capital asset to the shareholder and whether or not the corporation is completely liquidated. Any suspended losses may or may not be utilized.

## Deducting Shareholder's Suspended Pass-Through Losses

Cause of Suspended Loss	Treatment at Liquidation
Basis limitation. See <i>Shareholder Basis</i> , page 19-7.	Permanently lost. [Reg. §1.1366-2(a)(5)]
At-risk limitation. See <i>At-Risk Rules</i> , page 7-14, 1040 Edition/Deluxe Edition.	Offset gain recognized from disposition of stock. [Prop. Reg. §1.465-66(a)] Any remaining loss carried over indefinitely. [IRC §465(a)(2)]
Passive activity rules. See <i>Passive Activity Losses</i> , page 7-9, 1040 Edition/Deluxe Edition.	Suspended passive losses allowed. [IRC §469(g)(1)(A)] <i>Exception:</i> Loss is not allowed on the sale to a related party. [IRC §267(b)(2) and IRC §469(g)(1)(B)]

## S Corporation Taxes

### Cross References

- Schedule D (Form 1120S), *Capital Gains and Losses and Built-In Gains*
- Form 1120S, *U.S. Income Tax Return for an S Corporation*
- IRC §1363(d), IRC §1374, IRC §1375

### Related Topics

- Passive Activity Loss Limits, page 7-9, 1040 Edition/Deluxe Edition
- Inventory, page 8-14, 1040 Edition/Deluxe Edition



### S Corporation Pass Through

An S corporation passes income and losses through to shareholders. Income tax is generally paid by shareholders. However, where an S corporation was previously a C corporation, certain taxes may apply.

**Note:** Although an S corporation generally does not pay income taxes, taxes of doing business, such as payroll taxes, property taxes, etc., still apply.

### Excess Net Passive Income Tax (IRC §1375)

If a corporation has always been an S corporation, the excess net passive income tax does not apply.

Excess net passive income tax applies to an S corporation if:

- The corporation has accumulated earnings and profits at the close of its tax year,
- The corporation has passive investment income for the tax year in excess of 25% of gross receipts, and
- The corporation has excess net passive income.

**Excess net passive income (ENPI) tax computation.** Tax is 35% of excess net passive income. ENPI is calculated by the following formula, but cannot exceed taxable income computed as though the corporation were a C corporation.

$$\text{ENPI} = \text{NPI} \times [\text{PII} - (0.25 \times \text{GR})] \div \text{PII}$$

**NPI:** "Net passive income" is passive investment income, reduced by directly-connected deductions.

**PII:** "Passive investment income" includes gross receipts derived from royalties, rents, dividends, interest, and annuities. Gains from security sales are excluded. For purposes of passive investment income, gains and losses recognized for the built-in gains tax are not included.

**GR:** "Gross receipts" includes amounts received for sales of property, investments, and gains (but not losses) from sales of securities irrespective of date sold.

**Example:** Bec's Notions, Inc., an S corporation since 1994, has earnings and profits at the close of 2014, and taxable income of \$72,200. Income for the year includes the following:

- 1) Gross sales of \$100,000,
- 2) Sale of real estate for \$50,000, with adjusted basis of \$30,000,
- 3) Interest income of \$15,000,
- 4) Rent receipts of \$50,000, but with related expenses of \$35,000,
- 5) Sale of publicly-traded stock for \$7,000, with basis of \$10,000, and
- 6) The redemption of a corporate bond for \$15,000, which had been purchased for \$14,800.

Excess net passive income is calculated as follows:

PII includes interest income of \$15,000 and gross rent of \$50,000. The sale of stock and the gain on the redemption of the bond are not included. Neither of these transactions is subject to the built-in gains tax since more than ten years have passed since the S corporation election was effective.

NPI is \$30,000, which includes PII of \$65,000, less rental-related expenses of \$35,000.

GR includes gross sales of \$100,000, the total received for the real estate sale of \$50,000, interest income of \$15,000, rent receipts of \$50,000, and the gain of \$200 on the bond redemption. GR does not include the stock loss or the total proceeds from the bond.

Calculation of ENPI using the formula with the values derived above is as follows.

$$\text{ENPI} = \$30,000 \times [\$65,000 - (0.25 \times \$215,200)] \div \$65,000.$$

This reduces to  $\$30,000 \times (\$65,000 - \$53,800) \div \$65,000$ , or \$5,169.

Excess net passive income tax is 35% of the lesser of ENPI or taxable income. In this example, the corporation incurs an excess net passive income tax of \$1,809 (35% of \$5,169).

## Built-In Gains (BIG) Tax

If a corporation has always been an S corporation, built-in gains tax does not apply.

Built-in gains tax applies if:

- A C corporation elects S corporation status,
- The combined FMV of the corporation's property is greater than basis, and
- The property is sold or distributed within 10 years of the election to be taxed as an S corporation (within seven years of the S election for 2009 and 2010, and within five years of the S election for 2011 through 2014):

for all years after 2010. The 5-year recognition period provision is now permanent.

**Example:** Land Sakes

Corporation owns the following assets at the time it elects to be treated as an S corporation.

	FMV	Basis	Built-in gain or (loss)
Equipment.....	\$10,000	\$1,500	\$8,500
Attachments .....	\$500	\$2,800	(2,300)
Trailers.....	\$ 3,700	\$3,600	\$ 100
Total .....	\$14,200	\$7,900	\$6,300

Since the combined FMV of the corporation's property is greater than basis, the corporation is subject to built-in gains tax if the property is sold or distributed within 10 years.



Built-in gains tax also applies if the S corporation acquired an asset with a basis determined by reference to its basis in the hands of a C corporation. Built-in gains tax applies regardless of whether there is any accumulated earnings and profits at the end of the year.

**Installment sale.** If an S corporation sells an asset and reports the income from the sale using the installment method, the treatment of all payments received is subject to the built-in gains tax provisions applicable to the taxable year in which the sale was made.

**Tax rate.** Built-in gains tax is recognized if built-in gain property is sold or distributed. Tax is 35% of the net recognized built-in gain (limited to taxable income computed as if the corporation were a C corporation).

**Reporting.** Built-in gains tax is computed and reported on Schedule D, Form 1120S.

The cumulative built-in gain remaining for an S corporation is listed on Schedule B, Form 1120S (unrealized built-in gain reduced by recognized built-in gain from prior years).

**Pass through.** Built-in gains passing through to shareholders on Schedule K-1, Form 1120S, are reduced by the amount of built-in gains tax paid by the S corporation.

**Accounts receivable/payable.** Built-in gains are computed based on all corporation property, including accounts receivable and accounts payable.

**Example:** Doctor Jekyll owns Hyde's Medical Clinic, Inc., a C corporation using the cash method of accounting. On December 31, 2014, Hyde's Medical Clinic had \$85,000 of accounts receivable (AR) and \$20,000 of accounts payable (AP). Neither the accounts receivable nor accounts payable is reflected in taxable income. On January 1, 2015, Doctor Jekyll converts his C corporation into an S corporation. During the first three months of 2015, Hyde Medical Clinic collects all its accounts receivable and pays accounts payable that were outstanding on December 31, 2014.



Hyde Medical Clinic must pay tax on \$65,000 of built-in-gains (\$85,000 AR minus \$20,000 AP). The tax equals \$22,750 (\$65,000 × 35%). In addition, the \$65,000 of income passes through to Doctor Jekyll on Schedule K-1.

Doctor Jekyll is allowed a \$22,750 deduction against his \$65,000 K-1 income (netted on the K-1). Assuming Doctor Jekyll's personal tax rate is 28%, he must pay an additional tax of \$11,830 (\$42,250 × 28%), making total tax on the \$65,000 net profit equal to \$34,580 (\$22,750 + \$11,830) for a combined tax rate of 53.2%.

**Solution:** If in December 2014, Hyde Medical Clinic had accrued a bonus of \$65,000 payable to Dr. Jekyll, the built-in gains tax would not have applied.

Accounts receivable.....	\$85,000
Accounts payable.....	(20,000)
Bonus payable.....	(65,000)
Built-in gains.....	\$ 0

Note that for tax purposes, Hyde's Medical Clinic uses the cash method of accounting. The accrual basis is used only for purposes of computing built-in gains in 2014. Mr. Hyde's bonus can be paid in 2015 and can be funded by collection of the accounts receivable.

See *Reasonable Compensation*, page 19-13.

**Carryover losses/credits.** Any net operating loss or capital loss carryforward arising from a C corporation year is allowed as a deduction against built-in gains. Any business credit or minimum tax credit carryforward arising from such year is allowed as a credit against the built-in gains tax.

## Investment Credit Recapture Tax

An S corporation is liable for the investment credit recapture tax attributable to credit allowed for tax years for which the corporation was not an S corporation. If the S corporation prematurely disposes of property on which the investment credit was claimed, file Form 4255, *Recapture of Investment Credit*.

## Last-In-First-Out (LIFO) Recapture Tax

An S corporation may be liable for LIFO recapture tax if:

- The corporation used the LIFO inventory pricing method for its last tax year as a C corporation, or

- A C corporation transferred LIFO inventory to the corporation in a nonrecognition transaction in which those assets were transferred-basis property.

The additional tax due to LIFO recapture is figured for the corporation's last tax year as a C corporation or for the tax year of the transfer, whichever applies. The tax is paid in four equal installments. The C corporation must pay the first installment by the due date (not including extensions) of Form 1120. The S corporation must pay each of the remaining installments by the due date (not including extensions) for the three succeeding years. [IRC §1363(d)]



## Tax Payments

An S corporation must make estimated tax payments if estimated tax due is greater than \$500. Annualized methods may reduce the amount of one or more installments. See IRC section 6655(e).

Estimated payments are due on the 15th day of the 4th, 6th, 9th, and 12th months of the tax year.

Most businesses must make tax deposits electronically using the Electronic Federal Tax Payment System (EFTPS). See *How to Deposit*, page 23-3.

## Miscellaneous S Corporation Issues

### Cross References

- IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*
- IRS Pub. 587, *Business Use of Your Home*

### Related Topics

- Business Use of Home, page 5-12, 1040 Edition/Deluxe Edition
- Employee Fringe Benefits, Tab 13, 1040 Edition/Deluxe Edition
- Reasonable Compensation, page 18-12

## Employee Business Expense for S Corporation Shareholder

A shareholder of an S corporation cannot deduct expenses paid on behalf of the corporation without a corporate resolution.

**Court Case:** The taxpayer was a 50% shareholder and incurred vehicle expenses and office-in-home expenses in performing his duties as an employee of the corporation. The corporation had adopted a resolution requiring the taxpayer to incur expenses as may be necessary or required, and that they would not be reimbursed by the corporation. The resolution also required the taxpayer to supply office space and his own vehicle for his business services which would not be reimbursed by the corporation. The court ruled these expenses were deductible as employee business expenses which are miscellaneous itemized deductions, subject to the 2% AGI limitation. The court noted that the voluntary payment of corporate expenses by officers, employees, or shareholders are not deductible and must be considered capital contributions or loans to the corporation. However, a corporate resolution or policy in place requiring a corporate officer to assume certain expenses indicates that those expenses are his or her expenses as opposed to those of the corporation. (*Craft*, T.C. Memo 2005-197)

## Shareholder's Use of Home

If general requirements are met, a shareholder is allowed to deduct expenses for business use of the home, assuming the shareholder receives reasonable wages for services rendered. Such expenses are deducted as employee business expenses on Schedule A, Form 1040, subject to the 2% of AGI limitation. See *Business Use of Home*, page 5-12, 1040 Edition/Deluxe Edition.

**Exception for rental.** A taxpayer is not allowed to deduct expenses for business use of the home attributable to rent paid by the employer if the employee is providing services. The employer is allowed a deduction for rent paid, but the employee is not allowed a deduction for business use of the home. [IRC §280A(c)(6)]

## Reasonable Compensation

**Payment for services.** S corporations must pay reasonable compensation to a shareholder-employee in return for services that the employee provides to the corporation before non-wage distributions may be made to him or her. The amount of reasonable compensation will never exceed the amount received by the shareholder either directly or indirectly.

**Source of gross receipts.** Three major sources of an S corporation's gross receipts are:

- Services of the shareholder,
- Services on non-shareholder employees, or
- Capital and equipment.

If most of the gross receipts and profits are associated with the shareholder's personal services, then most of the profit distribution should be allocated as compensation. Additionally, the shareholder-employee should be compensated for administrative work performed for the other income producing employees or assets.

An officer that performs no service, or only minor service, to the corporation is not considered an employee.

**Reasonable compensation in the courts.** Several court cases support the authority of the IRS to reclassify other forms of payments to shareholder-employees as wages subject to employment taxes.

IRS Position	Court Rulings
Authority to reclassify	<ul style="list-style-type: none"> <li>• <i>Glass Blocks Unlimited</i>, T.C. Memo 2013-180</li> <li>• <i>Joly</i>, 6th Cir., March 20, 2000</li> </ul>
Reinforce employment status of shareholders	<ul style="list-style-type: none"> <li>• <i>Joseph M. Grey Public Accountant, P.C.</i>, 119 T.C. No. 121</li> <li>• <i>Veterinary Surgical Consultants, P.C.</i>, 117 T.C. No. 141</li> </ul>
Reasonable reimbursement for services performed	<ul style="list-style-type: none"> <li>• <i>Sean McAlary Ltd. Inc.</i>, T.C. Summary 2013-62</li> <li>• <i>David E. Watson, P.C.</i>, 8th Cir., February 21, 2012</li> </ul>

**Author's Comment:** Many S corporations are set up for the primary purpose of avoiding payroll taxes on wages to shareholders. This approach does not comply with tax law. A recent study identified the highest noncompliance issue in S corporations as being incorrect wages paid to shareholders. The growing number of S corporations and the fact that most of them are held by three or fewer shareholders makes this area a prime target for IRS audits. (TIGTA Ref. No. 2012-30-062)

**Factors considered in finding reasonable wages.** The following factors are often cited in court cases in relation to determining reasonable wages for an S corporation shareholder.

- Training and experience.
- Duties and responsibilities.
- Time and effort devoted to the business.
- Dividend history.
- Payments to non-shareholder employees.
- Timing and manner of paying bonuses to key people.
- What comparable businesses pay to key people.
- Compensation agreements.
- Usage of a formula to determine compensation.

**Note:** The IRS will also look at amounts paid to family members in determining whether reasonable wages were paid. If the compensation paid to a family member is not reasonable under the



circumstances, the IRS will make an adjustment to the tax of the corporation and the family member.

**Salary comparisons.** Comparable wage information specifically for S corporations can be obtained at: [www.payscale.com/salary-survey/aid-9176/](http://www.payscale.com/salary-survey/aid-9176/)

**Income taxed to the earner.** The existence of a validly organized and operated corporation does not preclude taxation of income to the service provider instead of the corporation. Income is taxable to the one who earns it.



**Court Case:** The taxpayer and his wife each owned separate S corporations under which they ran a tax preparation business and realtor business, respectively. Each taxpayer assigned payments received for their services to their respective corporations. Neither corporation paid either taxpayer wages for their services. Since there was not an employer-employee relationship, nor any contract between the corporation and the taxpayer giving the corporation the right to instruct or control the taxpayer's actions, the court upheld the IRS' position that the S corporations themselves did not earn the income. Rather, the taxpayers personally earned the income outside the corporation and, thus, were subject to self-employment tax. (*Arnold*, T.C. Memo 2007-168)

## Fringe Benefits for S Corporation Shareholders

For purposes of applying the rules for fringe benefits, an S corporation is treated as a partnership, and any shareholder with 2% or more ownership of the S corporation is treated as a partner. See *Employee Fringe Benefits*, Tab 13.

**Self-employed health insurance.** Guidance from the IRS allows a more than 2% shareholder-employee of an S corporation to deduct an above-the-line health insurance deduction, even if the policy is purchased in the name of the shareholder. The deduction is allowable if:

- The S corporation makes the premium payments for the policy covering the more than 2% shareholder-employee in the current tax year, or
- The more than 2% shareholder-employee makes the premium payments, furnishes proof of payment to the S corporation, and is reimbursed within the current tax year. (Notice 2008-1)

The premiums will not qualify if they are not paid or reimbursed by the S corporation and included in the shareholder's gross income on Form W-2.

The deduction is limited to the smaller of eligible health insurance premiums or net profit from the business. For a more than 2% shareholder-employee of an S corporation, net profit means Medicare wages from box 5 of his or her Form W-2. For additional rules, see *Self-employed health insurance deduction*, page 5-9, 1040 Edition/Deluxe Edition.

**Author's Comment:** Since the health insurance premiums are generally exempt from FICA tax, the employee needs to earn additional wages from the S corporation in an amount at least equal to the insurance premiums to ensure a full deduction.

## No Carryovers Between C and S Year

Carryover items, such as net operating losses and disallowed charitable contributions, cannot carry over from a C corporation to an S corporation. However, the statutes of limitation continue to run. [IRC §1371(b)]



**Example:** Barry Corp, a C corporation, sustained a net operating loss in 2013. Barry Corp elected to forgo the carryback period and opted instead to carry the net operating loss forward for 20 years. A portion of the net operating loss was used up in 2014, with an amount carried forward. On January 1, 2015, Barry Corp elected to be taxed as an S corporation. Although the net operating loss is not used up, it may not be used by the S corporation, and 2015 is the second year in the 20-year carryforward term. If Barry Corp remains an S corporation until the end of the 20-year carryforward term, the net operating loss may not be used.

**Built-in gains tax exception.** Net operating losses and capital losses carry over to an S corporation for purposes of computing built-in gains tax. See *Built-In Gains (BIG) Tax*, page 19-12.

**Passive losses exception.** Losses suspended under passive loss limitation rules may carry over from a C corporation to an S corporation.

**Court Case:** A C corporation had losses on rental property. The losses were not allowed under passive loss rules. In a later year, the corporation elected S corporation status, sold the properties, and deducted the suspended losses. The IRS and Tax Court disallowed the losses because of the rule that prohibits carryovers from a C to an S corporation. The 10th Circuit Court of Appeals found in favor of the taxpayer, stating that the rule did not apply to passive losses. The losses were allowed. (*St. Charles Investment Company*, 10th Cir., November 14, 2000)

## S Corporation Example

**Greener Pastures, Inc.** This example is part of a series that follows the business cycle of "Greener Pastures" from concept to inception, start-up to the end of the first tax year, then through completion of the tax return and reporting income to owners. The example illustrates how business transactions are reported for an S corporation and includes books, financial statements, and line-by-line illustrations of how to complete Form 1120S, *U.S. Income Tax Return for an S Corporation*.

Compare this *S Corporation Example* to the *C Corporation Example* on page 18-20 and to the *Partnership Example* in Tab 20.



**Principles of S corporation taxation.** For federal tax purposes, an S corporation is a pass-through entity. S corporation income and deductions are reported on Form 1120S, then passed through to shareholders on Schedule K-1 (1120S). S corporation shareholders pay tax on income as it is earned, whether or not the income is distributed to the shareholder. Distributions to shareholders are generally not taxable up to the amount of the shareholder's basis in stock and/or loans. See *Shareholder Basis*, page 19-7.

**Differences in reporting for an S corporation.** The following items are reported differently for S corporations as compared with C corporations and partnerships.

**Employee-shareholders of corporations.** Unlike a partnership, corporation shareholders are paid wages by the corporation, the same as any other employee. Wages paid to shareholders are deducted from income of an S corporation.

**Fringe benefits.** Although fringe benefits are generally tax free to employee-shareholders in C corporations, in S corporations employee-shareholders who own 2% or more of the corporation are treated the same as partners. This means that most fringe benefits are included in income for a 2% shareholder of an S corporation.

**S corporation taxation.** An S corporation does not pay income tax at the entity level. Income, losses, deductions, and credits flow through to shareholders for reporting on their individual returns. S corporation shareholders pay tax on income at the time it is earned without regard for whether the income is withdrawn. Distributions of cash or property from an S corporation are generally not taxable up to the shareholder's adjusted basis in stock. See *Distributions*, page 19-10.

**Section 179 deduction.** In an S corporation, the Section 179 expense is not deducted from S corporation income. The amount is instead passed through to shareholders as a separately stated item. See *Separately Stated Items*, page 19-7.



## Scenario

Nate owned a lawn and garden implement store. Tyler owned a hydroseeding business. Nate and Tyler decided to go into business together under the name "Greener Pastures."

**Creating an S corporation.** Nate and Tyler consulted an attorney for advice about the choice of business entity. The attorney recommended that they operate their business as a corporation and began the process of filing the necessary documents with the Secretary of State. The attorney also assisted them in drafting an incorporation agreement. See *Incorporation Agreement*, below. Upon creation of the corporation, the official name of the company became "Greener Pastures, Inc."

- The attorney's fee was \$2,000.

**Tax advice.** The tax consultant for Greener Pastures, Inc. recommended that the corporation make the election to be taxed as an S corporation and assisted in filing the election. See *Form 2553, Election by a Small Business Corporation*, page 19-4.

The tax consultant obtained an employer identification number (EIN) for the business. See page 5-1, *1040 Edition/Deluxe Edition*, for information about obtaining an EIN. The consultant also instructed Nate and Tyler to open a business checking account and to make cash contributions to capital. The bookkeeping system was set up and procedures were put in place to provide for compensation and benefits for the shareholders.

- The tax consultant's fee was \$2,500.

## Incorporation Agreement

The incorporation agreement for Greener Pastures, Inc., contains the following provisions.

**Stock authorized.** The corporation authorized 500,000 shares of stock at par value of \$1.00 per share.

**Capital contributions.** Nate made a capital contribution in the amount of \$55,000 in exchange for 55,000 shares of stock. Tyler made a capital contribution in the amount of \$45,000 for 45,000 shares of stock. After the capital contributions, the corporation has 100,000 shares of outstanding stock.

**Note:** No gain or loss is recognized when cash is contributed to a corporation in exchange for stock.

**Shareholder wages.** The S corporation will pay wages of \$55,755 to Nate and \$44,245 to Tyler. The corporation will pay health insurance premiums and make HSA contributions for each shareholder-employee. See *Employee benefits*, next column. Total shareholder wages reported are \$60,905 (\$55,755 + \$1,800 + \$3,350) for Nate, and \$49,395 (\$44,245 + \$1,800 + \$3,350) for Tyler.



**Did You Know?** Health insurance benefits paid for more than 2% shareholders of an S corporation are taxable as wages but are not subject to FICA. The amount of the self-employed health insurance deduction should be reported in box 14 of the employee-shareholder's Form W-2. The shareholder is then able to deduct this amount as adjustments to income on Form 1040. Since the employee-shareholder's wages are increased by health benefits, that also increases the compensation for purposes of computing the employer's match for the SIMPLE plan.

In a reverse situation compared with health benefits, employee elective deferrals to a SIMPLE plan are not subject to income tax but are subject to FICA. See the instructions for Form 1120S, lines 7 and 8, page 19-18, for information about reporting these amounts.

See *Self-employed health insurance*, page 19-14, for information about health insurance policies taken out under an S corporation.

**Employee benefits.** The corporation will pay premiums of \$1,800 for each employee, which is 100% of the cost of their high-deductible medical insurance purchased through a Small Business Health Options Program (SHOP) Marketplace. It will also contribute to both HSA and SIMPLE plans for each employee.

**Health savings accounts.** The corporation will contribute \$3,350 to an HSA for each individual. See *Line 18, Employee benefit programs*, page 19-18, for how to report on Form 1120S. See also *Health Savings Accounts*, Tab 13, *1040 Edition/Deluxe Edition*, for more information about HSAs.

**SIMPLE plan.** The S corporation will contribute to Savings Incentive Match Plans for Employees (SIMPLE plans) by establishing SIMPLE IRAs. The corporation will match employee elective deferrals dollar-for-dollar up to 3% of each employee's wages.

**Note:** Health benefits for S corporation shareholder-employees increase taxable wages, and, therefore, increase the employer matching amount for their SIMPLE contributions. See *Savings Incentive Match Plans for Employees (SIMPLE plans)*, Tab 13, *1040 Edition/Deluxe Edition*.

**Employee-shareholder expenses.** Shareholders are personally responsible for paying for their own professional publications, association dues, and sanctioning fees. As corporation shareholders, these amounts will be deducted as employee business expenses on the individual tax returns, subject to the 2% of AGI limitation for employee business expenses. Compare to the same expenses in the *Partnership Example* in Tab 20, which are fully deductible and also reduce self-employment taxes.

**Did You Know?** Although an employee-shareholder can deduct employee business expenses, a shareholder of an S corporation cannot deduct expenses paid on behalf of a corporation unless a corporate resolution or policy requires payment of the expense. See *Employee Business Expense for S Corporation Shareholder*, page 19-13.

**Tax year.** The S corporation adopts a calendar tax year. The first tax year is a short tax year beginning on April 1, 2015, and ending on December 31, 2015. The corporation will establish its calendar tax year with the IRS when it files its first income tax return. See *Accounting Periods and Methods*, page 8-21, *1040 Edition/Deluxe Edition*, and *Short Tax Year Depreciation*, page 9-5, *1040 Edition/Deluxe Edition*.

**Accounting method.** The S corporation will use the cash method of accounting.

**Note:** The S corporation will hold inventory consisting of lawn and garden implements and hydroseeding materials. Under the general rule, if a company carries inventory, the accrual method of accounting must be used for purchases and sales. However, businesses with average gross receipts of \$1 million or less are eligible to use the cash method of accounting. Even though Greener

*continued on page 19-17*

## Payroll Report for Year Ended December 31, 2015

Employee	Gross Earnings	Social Security 6.20%	Medicare 1.45%	Federal Withholding	State Withholding	Health Insurance & HSA Contributions	SIMPLE Elective Deferrals	Net Pay
Nate	\$ 60,905.00	\$ 3,456.81	\$ 808.45	\$ 9,204.00	\$ 3,336.00	\$ 5,150.00	\$ 5,500.00	\$ 33,449.74
Tyler	\$ 49,395.00	\$ 2,743.19	\$ 641.55	\$ 6,324.00	\$ 1,924.00	\$ 5,150.00	\$ 4,500.00	\$ 28,112.26
Evan	\$ 31,200.00	\$ 1,934.40	\$ 452.40	\$ 3,912.00	\$ 1,632.00		\$ 3,120.00	\$ 20,149.20
Cyndi	\$ 26,000.00	\$ 1,612.00	\$ 377.00	\$ 3,120.00	\$ 1,272.00		\$ 2,600.00	\$ 17,019.00
Tristan	\$ 20,800.00	\$ 1,289.60	\$ 301.60	\$ 2,328.00	\$ 996.00		\$ 2,080.00	\$ 13,804.80
Jordan	\$ 20,800.00	\$ 1,289.60	\$ 301.60	\$ 2,328.00	\$ 996.00		\$ 2,080.00	\$ 13,804.80
Totals	\$209,100.00	\$12,325.60	\$2,882.60	\$27,216.00	\$10,156.00	\$10,300.00	\$19,880.00	\$126,339.80

### Final Pay Period—Taxes Deposited January 2016

	Gross Earnings	Social Security 6.20%	Medicare 1.45%	Federal Withholding	State Withholding	Health Insurance HSA Contributions	SIMPLE Elective Deferrals	Net Pay
	\$ 3,823.08	\$ 237.03	\$ 55.43	\$ 523.38	\$ 195.31		\$ 382.31	\$ 2,429.61

## 2015 Depreciation Schedule—Greener Pastures, Inc.

Asset	Placed in Service	Basis	Section 179	Depreciable Basis	Recovery Period	Method
Equipment	April 1, 2015	\$23,600.00	\$23,600.00	\$ 0.00	7 yr.	200DB
Display shelving	April 1, 2015	\$ 8,950.00	\$ 0.00	\$ 8,950.00	7 yr.	200DB
Office furniture	April 1, 2015	\$ 3,675.00	\$ 0.00	\$ 3,675.00	7 yr.	200DB
Computers	April 1, 2015	\$ 3,890.00	\$ 0.00	\$ 3,890.00	5 yr.	200DB
Totals		\$40,115.00	\$23,600.00	\$16,515.00		

### Regular Tax Depreciation—Short Tax Year 200DB

Display shelving	$\$8,950 \times \frac{1}{7} \times 200\% \times \frac{4.5}{12} = \$ 959$
Office furniture	$\$3,675 \times \frac{1}{7} \times 200\% \times \frac{4.5}{12} = \$ 394$
Computers	$\$3,890 \times \frac{1}{5} \times 200\% \times \frac{4.5}{12} = \$ 584$
Total regular tax depreciation	\$1,937

**AMT—Short Tax Year 150DB.** Refigure depreciation for AMT purposes for property depreciated using the 200% DB method by using the 150% DB method with the same convention and recovery period. Costs recovered under Section 179 do not need to be added back for AMT.

Display shelving	$\$8,950 \times \frac{1}{7} \times 150\% \times \frac{4.5}{12} = \$ 719$
Office furniture	$\$3,675 \times \frac{1}{7} \times 150\% \times \frac{4.5}{12} = \$ 295$
Computers	$\$3,890 \times \frac{1}{5} \times 150\% \times \frac{4.5}{12} = \$ 438$
Total AMT depreciation	\$1,452

**AMT depreciation adjustment:** \$1,937 – \$1,452 = \$485

## Balance Sheet—Greener Pastures, Inc.

December 31, 2015

<b>Assets:</b>	
Cash	\$142,117.29
Inventory	9,100.00
Equipment	23,600.00
Display shelving	8,950.00
Office furniture	3,675.00
Computers	3,890.00
Accumulated depreciation	(25,537.00)
Total assets	\$165,795.29
<b>Liabilities:</b>	
Withholding payable	\$ 1,011.16
SIMPLE employee deferrals payable	382.31
Sales tax payable	1,234.64
Loan payable	20,459.27
Total liabilities	\$ 23,087.38
<b>Equity:</b>	
Common stock	\$100,000.00
Current earnings	52,707.91
Distributions	(10,000.00)
Total equity	\$142,707.91
Total liabilities plus equity	\$165,795.29

## Income Statement—Greener Pastures, Inc.

Year ended December 31, 2015

### Revenue:

Lawn and garden implement sales	\$215,500.00
Hydroseeding services	212,450.00
Interest earned	566.00
Gross income	\$428,516.00

### Cost of goods sold:

Beginning inventory	\$ 0.00
Purchases	74,025.00
Ending inventory	(9,100.00)
Cost of goods sold	\$ 64,925.00
Gross profit	\$363,591.00

### Expenses:

Accounting (organization costs)	\$ 2,500.00
Advertising	3,000.00
Attorney fees (organization costs)	2,000.00
Bookkeeping	2,800.00
Depreciation	25,537.00
Employee benefit programs	
HSA contributions	13,400.00
Health insurance	7,200.00
SIMPLE employer match	6,273.00
Insurance—business	3,250.00
Interest expense	916.36
Meals and entertainment	1,100.00
Office expenses	2,325.00
Payroll taxes	17,971.73
Rent	9,000.00
Travel (start-up costs)	1,660.00
Utilities	2,850.00
Wages (includes \$6,600 for shareholder HSA contributions and \$9,000 for health insurance)	209,100.00
Total expenses	\$310,883.09
Net income per books	\$ 52,707.91



# Cash Flow Reconciliation

Business Name: Greener Pastures, Inc.	Period: 4/1/15 to 12/31/15	EIN: 31-2345678
1) Starting cash balance .....	1)	0.00
<b>Cash In</b>		
2) Customer receipts: categories		
Lawn and garden implement sales		215,500.00
Hydroseeding services		212,450.00
Sales tax collected		14,815.63
Total customer receipts.....	2)	442,765.63
3) Investment income: interest, dividends, etc.		
Interest income		566.00
Total investment income.....	3)	566.00
4) Cash received from accounts receivable not listed elsewhere .....	4)	
5) Cash received from sale of assets .....	5)	
6) Cash received from loan repayments.....	6)	
7) Cash received from loan proceeds .....	7)	
8) Contributions to capital .....	8)	100,000.00
9) Other receipts.....	9)	
Total starting cash balance plus cash in.....		543,331.63
<b>Cash Out</b>		
10) Business expenses: categories		
Accounting (organization costs)		2,500.00
Advertising		3,000.00
Attorney fees (organization costs)		2,000.00
Bookkeeping		2,800.00
Employee benefit programs:		
HSA contributions (includes \$6,700 for shareholders)		20,100.00
Health insurance (includes \$3,600 for shareholders)		10,800.00
SIMPLE plan employer match		6,273.00
SIMPLE plan employee elective deferrals		19,497.69
Insurance—business		3,250.00
Meals and entertainment		1,100.00
Office expenses		2,325.00
Payroll taxes:		
Federal unemployment (FUTA)		252.00
Federal quarterly (Form 941)		56,524.08
State unemployment		2,804.00
State withholding		9,960.69
Rent		9,000.00
Sales tax		13,580.99
Travel (start-up costs)		1,660.00
Utilities		2,850.00
Wages/net		126,339.80
Total business expenses .....	10)	296,617.25
11) Purchases of inventory.....	11)	74,025.00
12) Loans payable		
Asset    Equipment		
Principal   3,140.73   Interest   916.36   = Total.....		4,057.09
Total loans payable.....	12)	4,057.09
13) Paid on accounts payable.....	13)	
14) Cash disbursements on loans receivable.....	14)	
15) Cash distributions to owners.....	15)	10,000.00
16) Cash paid for asset purchases.....	16)	16,515.00
17) Other cash out: categories	17)	
Total cash out for period .....		401,214.34
Ending cash balance.....		142,117.29

continued from page 19-15

Pastures, Inc. will use the cash method of accounting, the cost of inventory cannot be deducted until the products are sold. For more information about accounting for inventory, see *Inventory/Cost of Goods Sold*, page 8-14, 1040 Edition/Deluxe Edition.

## Organizational and Start-Up Costs

Organizational costs and start-up costs are capital expenses. An election is available to deduct up to \$5,000 in organizational costs and \$5,000 in start-up costs for tax purposes. Amortization is available for amounts in excess of the limits. The attorney's fee of \$2,000 and the tax consultant's fee of \$2,500 are organizational costs.

The travel expenses of \$1,660 were incurred visiting prospective suppliers in advance of the business start date of April 1, 2015. Because they were incurred before the business started operating, they are classified as start-up costs.

Greener Pastures, Inc. will elect to deduct its organizational costs and start-up costs for tax year 2015. See *Start-Up Costs and Organizational Costs*, page 18-10.

## Purchase of Assets

Greener Pastures Inc. took out a bank loan of \$23,600 to purchase equipment for hydroseeding. It paid cash for display shelving, office furniture, and computers, totaling \$16,515.

Equipment.....	\$23,600
Display shelving .....	8,950
Office furniture .....	3,675
Computers.....	3,890
Total.....	\$40,115

## Section 179 deduction and depreciation.

A Section 179 deduction of up to \$25,000 is available for tax year 2015. Greener Pastures, Inc. elects to claim a Section 179 deduction for the equipment only. The remaining assets will be depreciated for tax purposes under regular MACRS using a short tax year.

Note that the Section 179 deduction is not taken as an expense against taxable income on Form 1120S. For an S corporation, any amount claimed as a Section 179 deduction is passed through to shareholders on Schedule K-1 (Form 1120S). The shareholders in this example will deduct the Section 179 expense from Schedule K-1 on page 2, Schedule E (Form 1040).

**Short tax year depreciation.** Since the S corporation's first year is less than 12 months, depreciation cannot be computed using the MACRS percentage tables. See *Short Tax Year Depreciation*, page 9-5, 1040 Edition/Deluxe Edition.

See *2015 Depreciation Schedule—Greener Pastures, Inc.*, page 19-16.

## Payroll

**Employees.** Greener Pastures Inc. hired Evan to assist Tyler with hydroseeding, Cyndi as an assistant store manager, and Tristan and Jordan as sales people. In addition to wages, the corporation will provide health benefits through HSAs and retirement benefits through a SIMPLE plan. See *Payroll Report for Year Ended December 31, 2015*, page 19-16.

## Distributions

In December 2015, Greener Pastures Inc. made cash distributions of \$5,500 to Nate and \$4,500 to Tyler. The distributions were made pro rata based on stock ownership, and, therefore, did not violate the one-class-of-stock rule. See *One-Class-of-Stock Rule*, page 19-3.



## Financial Statements

The balance sheet and income statement for the short year ended December 31, 2015, along with the depreciation schedule and payroll report for Greener Pastures, Inc. can be found on page 19-16. A cash flow reconciliation statement for the short year is found on page 19-17.

## Line-by-Line Instructions (Form 1120S)

### Heading information:

**Item B.** Principal business activity codes, see page 24-2.

**Item D.** See page 5-1, *1040 Edition/Deluxe Edition*, for information about how to apply for an EIN.

**Item F.** Enter the corporation's total assets at the end of the tax year. If there are no assets at the end of the tax year, enter -0-. If the corporation is required to complete Schedule L, total assets from Schedule L, line 15, column (d) should match page 1, item F.

**Item H.** If the name or address of the corporation has changed since the last return was filed, check the appropriate box on item H. If a change in address occurs after the return is filed, use Form 8822-B, *Change of Address—Business*, to notify the IRS. See *Change of Name or Address*, page 18-4.

## Income

**Line 1. Gross receipts or sales.** Enter gross receipts or sales from all trade or business operations.

In this example, lawn and garden implement sales of \$215,500 and hydroseeding sales of \$212,450 add up to \$427,950 total sales.

**Line 2. Cost of goods sold (COGS).** The COGS is computed on Form 1125-A, *Cost of Goods Sold*, and carried to line 2.

In this example, COGS equals \$64,925.



## Deductions

**Line 7. Compensation of officers.** Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts represent reasonable compensation for services. Enter these amounts on line 7. The corporation determines who is an officer under the laws of the state where it is incorporated.

In this example, the compensation of officers is \$100,300. Although gross earnings on the payroll report show a combined total of \$110,300 for the officers, the elective deferrals totaling \$10,000 for the officers are combined with pension contributions for other

employees and are reported as part of the total on line 17, *Pension, profit-sharing, etc., plans*.

**Line 8. Salaries and wages.** Salaries and wages of employees who are not officers are reported on line 8.

If the corporation claims a credit for wages paid or incurred, it may need to reduce the deduction for officers' compensation and salaries and wages. See *Reducing Certain Expenses for Which Credits Are Allowable*, page 30-4, *Small Business Edition*.

In this example, the deductible salaries and wages amount is \$85,320. The payroll report shows gross earnings of the employees of \$98,800, which are reduced by combined elective deferrals to a SIMPLE plan in the amount of \$9,880. This amount is further reduced by \$3,600 for the allowable Credit for Small Employer Health Insurance Premiums. For an example of how to calculate the credit, see *Credit for Small Employer Health Insurance Premiums*, page 30-15, *Small Business Edition*.

The \$9,880 in elective deferrals made by the employees are combined with other contributions to the SIMPLE plan, including officers' elective deferrals and employer matching amounts, and reported on line 17, *Pension, profit-sharing, etc. plans*.

**Line 11. Rents.** Enter rent paid on business property used in a trade or business activity.

In this example, the corporation paid \$9,000 during the year for facility rental.

**Line 12. Taxes and licenses.** Enter taxes and licenses paid or incurred in the trade or business activities of the S corporation unless they are reflected in cost of goods sold. Federal import duties and federal excise and stamp taxes are deductible only if paid or incurred in carrying on the trade or business of the corporation.

In this example, taxes of \$17,972 (rounded) reported on line 12 consist of the employer portion of Social Security and Medicare (\$15,208.20) less accrued employer taxes payable in 2016 (\$292.46) plus FUTA (\$252), and state unemployment tax (\$2,804).

**Line 13. Interest.** Include interest expense incurred in the trade or business activities that is not claimed elsewhere on the return. In this example, \$916 (rounded) in interest was paid on the loan for the equipment.

**Line 14. Depreciation.** Report only the depreciation claimed on assets used in a trade or business activity. Complete and attach Form 4562, *Depreciation and Amortization*, only if the corporation placed property in service during the tax year or claims depreciation on any car or other listed property.

Do not include any Section 179 expense on this line. The Section 179 expense is separately stated and is passed through to shareholders on Schedule K-1.

In this example, regular depreciation is \$1,937. The Section 179 deduction of \$23,600 is passed through to shareholders on Schedule K-1 in proportion to their percentages of stock ownership. See *2015 Depreciation Schedule—Greener Pastures, Inc.*, page 19-16.

**Line 17. Pension, profit-sharing, etc. plans.** Include deductible contributions not claimed elsewhere on the return for corporation employees under a qualified pension, profit sharing, annuity, or simplified employer pension (SEP) or SIMPLE plan, and under any other deferred compensation plan. If the corporation contributes to an IRA for employees, include the contributions in salaries and wages.

In this example, \$26,153 consists of \$19,880 employee SIMPLE deferrals plus \$6,273 employee SIMPLE matching contribution.

**Line 18. Employee benefit programs.** Report amounts for fringe benefits paid or incurred on behalf of employees owning 2% or less of the corporation's stock. See *Employee Fringe Benefits*, Tab 13, *1040 Edition/Deluxe Edition*.

Form <b>1120S</b>	<b>U.S. Income Tax Return for an S Corporation</b>		OMB No. 1545-0123
Department of the Treasury Internal Revenue Service	Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.		<b>2015</b>
For calendar year 2015 or tax year beginning <b>4/1, 2015</b> , ending <b>12/31, 2015</b>			
A S election effective date <b>4/1/15</b>	TYPE Name <b>Greener Pastures, Inc.</b>	D Employer identification number <b>31-2345678</b>	E Date incorporated <b>4/1/15</b>
B Business activity code number (see instructions) <b>444200</b>	OR PRINT Number, street, and room or suite no. If a P.O. box, see instructions. <b>123 Prairie Point</b>	F Total assets (see instructions) <b>\$ 165,795</b>	
C Check if Sch. M-3 attached <input type="checkbox"/>	City or town, state or province, country, and ZIP or foreign postal code <b>Farmdale, MN 55555</b>		
G Is the corporation electing to be an S corporation beginning with this tax year? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No If "Yes," attach Form 2553 if not already filed			
H Check if: (1) <input checked="" type="checkbox"/> Final return (2) <input type="checkbox"/> Name change (3) <input type="checkbox"/> Address change (4) <input type="checkbox"/> Amended return (5) <input type="checkbox"/> S election termination or revocation			
I Enter the number of shareholders who were shareholders during any part of the tax year <b>2</b>			
Caution: Include only trade or business income and expenses on lines 1a through 21. See the instructions for more information.			
Income	1a Gross receipts or sales	1a <b>427,950</b>	
	b Returns and allowances	1b	
	c Balance. Subtract line 1b from line 1a	1c <b>427,950</b>	
	2 Cost of goods sold (attach Form 1125-A)	2 <b>64,925</b>	
	3 Gross profit. Subtract line 2 from line 1c	3 <b>363,025</b>	
	4 Net gain (loss) from Form 4797, line 17 (attach Form 4797)	4	
5 Other income (loss) (see instructions—attach statement)	5		
6 Total income (loss). Add lines 3 through 5	6 <b>363,025</b>		
Deductions (see instructions for limitations)	7 Compensation of officers (see instructions—attach Form 1125-E)	7 <b>100,300</b>	
	8 Salaries and wages (less employment credits)	8 <b>85,320</b>	
	9 Repairs and maintenance	9	
	10 Bad debts	10	
	11 Rents	11 <b>9,000</b>	
	12 Taxes and licenses	12 <b>17,972</b>	
	13 Interest	13 <b>916</b>	
	14 Depreciation not claimed on Form 1125-A or elsewhere on return (attach Form 4562)	14 <b>1,937</b>	
	15 Depletion (Do not deduct oil and gas depletion.)	15	
	16 Advertising	16 <b>3,000</b>	
	17 Pension, profit-sharing, etc., plans	17 <b>26,153</b>	
	18 Employee benefit programs	18 <b>20,600</b>	
	19 Other deductions (attach statement)	19 <b>17,935</b>	
	20 Total deductions. Add lines 7 through 19	20 <b>283,133</b>	
	21 Ordinary business income (loss). Subtract line 20 from line 6	21 <b>79,892</b>	
Tax and Payments	22a Excess net passive income or LIFO recapture tax (see instructions)	22a	
	b Tax from Schedule D (Form 1120S)	22b	
	c Add lines 22a and 22b (see instructions for additional taxes)	22c <b>0</b>	
	23a 2015 estimated tax payments and 2014 overpayment credited to 2015	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	23d	
24 Estimated tax penalty (see instructions). Check if Form 2220 is attached <input type="checkbox"/>	24		
25 Amount owed. If line 23d is smaller than the total of lines 22c and 24, enter amount owed	25 <b>0</b>		
26 Overpayment. If line 23d is larger than the total of lines 22c and 24, enter amount overpaid	26		
27 Enter amount from line 26 Credited to 2016 estimated tax <input type="checkbox"/> Refunded <input type="checkbox"/>	27		
Sign Here	Name <b>Nate</b> CEO Signature of officer _____ Date _____ Title		May the IRS discuss this return with the preparer shown below (see instructions)? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
Paid Preparer Use Only	Print/Type preparer's name _____ Preparer's signature _____ Date _____	Check <input type="checkbox"/> if self-employed PTIN _____	Firm's name _____ Firm's EIN _____ Phone no. _____
For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11510H Form <b>1120S</b> (2015)			

**Credit for Small Employer Health Insurance Premiums.** In this example, Greener Pastures, Inc. qualifies for a credit of \$3,600. For an example of how to calculate the credit, see *Credit for Small Employer Health Insurance Premiums*, page 30-15, *Small Business Edition*.

The credit of \$3,600 is listed on line 13g, *Other credits*, using code P. The credit is identified in the space provided and a copy of Form 8941, *Credit for Small Employer Health Insurance Premiums*, will be attached to Form 1120S.

### Schedules K and K-1 (Form 1120S)

Shareholders are liable for tax on their share of the corporation's income and must include their share of the income on their tax return whether or not it is distributed to them.

**Schedule K.** Schedule K is a summary schedule of all shareholders' shares of the corporation's income, deductions, credits, etc.



In this example, the following items are reported on Schedule K.

- Line 1, Ordinary business income, \$79,892.
- Line 4, Interest income, \$566.
- Line 11, Section 179 deduction, \$23,600.
- Line 13g, code P, Credit for Small Employer Health Insurance Premiums, \$3,600. See *Credit for Small Employer Health Insurance Premiums*, above.
- Line 15a, Post-1986 depreciation adjustment (for AMT), \$485. See *Depreciation Schedule—Greener Pastures, Inc.*, page 19-16.
- Line 16c, Nondeductible expenses, \$4,150. Nondeductible expenses consist of the \$550 nondeductible portion of meals and entertainment ( $\$1,100 \times 50\%$ ), and the \$3,600 reduction in salaries and wages due to the Credit for Small Employer Health Insurance Premiums.
- Line 16d, Distributions, \$10,000. See *Distributions*, page 19-18.
- Line 17a, Investment income, \$566.

**Schedule K-1.** Schedule K-1 shows each shareholder's separate share of items from Schedule K. Attach a copy of each Schedule K-1 to the Form 1120S filed with the IRS. Also provide the appropriate copy of Schedule K-1 to each shareholder.

See *S Corporation K-1 Codes*, page 7-3, *1040 Edition/Deluxe Edition*.

In this example, the following items are reported to Nate on Schedule K-1 for reporting on his individual income tax return.

- Line 1, Ordinary business income, \$43,941.
- Line 4, Interest income, \$311.
- Line 11, Section 179 deduction, \$12,980.

continued on next page

Report amounts that are paid on behalf of more than 2% shareholders as wages on line 7 or line 8, whichever applies.

In this example, the S corporation made contributions to HSAs for each shareholder in the amount of \$3,350 and paid health insurance premiums for each in the amount of \$1,800, for a total of \$10,300. Because the shareholders own more than 2% of the stock, the HSA contributions and the health insurance premiums are taxable and included as wages on the shareholders' Forms W-2. The \$20,600 deducted on line 18 consists of \$13,400 HSA contributions plus \$7,200 health insurance premiums paid on behalf of non-shareholder employees.



**Line 19. Other deductions.** Attach a schedule listing by type and amount of each deduction included on this line.

Following is a statement of other deductions for this example.

#### Statement of Other Deductions— Line 19, Form 1120S

Accounting (organization costs)	\$2,500
Attorney fees (organization costs)	\$2,000
Bookkeeping	\$2,800
Insurance-business	\$3,250
Meals and entertainment ( $1,100 \times 50\%$ )	\$550
Office expenses	\$2,325
Travel and lodging (start-up costs)	\$1,660
Utilities	\$2,850
Total other deductions	\$17,935

- Line 13, code P, Credit for Small Employer Health Insurance Premiums, \$1,980. See *Credit for Small Employer Health Insurance Premiums*, above.
- Line 15, code A, Depreciation adjustment for AMT purposes, \$267. See *Depreciation Schedule—Greener Pastures, Inc.*, page 19-16.
- Line 16, code C, Nondeductible expenses, \$2,283.
- Line 16, code D, Distributions, \$5,500. See *Distributions*, page 19-18.
- Line 17, code A, Investment income, \$311.
- Line 17, code V, Shareholder's HSA contribution, \$3,350.
- Line 17, code V, Shareholder's health insurance premiums, \$1,800.

**Note:** Line 17, code V, Other information, should be used to report any information the shareholders need to prepare their tax returns that is not specified on another line.

## Schedule L—Balance Sheet per Books

The balance sheet on Form 1120S should agree with the S corporation's books and records.

Schedule L is not required to be completed if the corporation answered "Yes" to question 8 on Schedule B (total receipts and total assets less than \$250,000). If the balance sheet is required to be completed, enter the total assets from line 15, Schedule L on page 1, Form 1120S, item F.



**Author's Comment:** A corporation that is not required to complete Schedules L and M-1 still must maintain adequate books and records for income tax purposes. Adequate books and records generally consist of a general ledger, trail balance, balance sheet, and income statement. Completing Schedules L and M-1, even when not required, may be beneficial in assuring that the tax return has been prepared properly based on book income.

Corporations with total assets of \$10 million or more on the last day of the tax year must complete Schedule M-3 instead of Schedule M-1. See the instructions for Schedule M-3 for provisions that affect Schedule L.

If the S election terminated during the tax year, and the corporation reverted to a C corporation, the year-end balance sheet should generally agree with the books and records at the end of the C short year. However, if the corporation elected under IRC section 1362(e)(3) to have items assigned to each short year under normal tax accounting rules, the year-end balance sheet should agree with the books and records at the end of the S short year.

**Line 24. Retained earnings.** If the corporation maintains separate accounts for appropriated and unappropriated retained earnings, it may want to continue such accounting for purposes of preparing its financial balance sheet. Also, if the corporation converts to C corporation status in a subsequent year, it will be required to report its appropriated and unappropriated retained earnings on separate lines of Schedule L, Form 1120.

## Schedule M-1—Reconciliation of Income (Loss) per Books with Income (Loss) per Return

Schedule M-1 is not required to be completed if the corporation answered "Yes" to question 8 on Schedule B (total receipts and total assets less than \$250,000).

Corporations with total assets of \$10 million or more on the last day of the tax year must complete Schedule M-3 instead of Schedule M-1.

For more information, see *Schedule M-1, Reconciliation of Income (Loss) per Books With Income per Return*, page 27-3, *Small Business Edition*.

**Line 3. Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 14I.** In this example, items reported on this line are:

- Nondeductible meal and entertainment expenses of \$550.
- Reduction to salaries and wages expense due to the Credit for Small Employer Health Insurance Premiums of \$3,600.



## Schedule M-2

Schedule M-2 is an analysis of accumulated adjustments account, other adjustments account, and shareholders' undistributed taxable income previously taxed.

**Column (a). Accumulated adjustments account (AAA).** On the first day of the corporation's first tax year as an S corporation, the balance of AAA is zero. See *Accumulated Adjustment Account (AAA)*, page 19-10.

**Line 2. Ordinary income from page 1, line 21.** In this example, ordinary income from page 1, line 21 is \$79,892.

**Line 3. Other additions.** Increase AAA by income (other than tax-exempt income) which has been allocated to shareholders on Schedule K. In this example, other additions consists of \$566 interest income.

**Line 5. Other reductions.** Generally, decrease AAA by deductible losses and expenses, nondeductible expenses (other than expenses related to tax-exempt income), allocated to shareholders on Schedule K. In this example, other reductions consists of Section 179 deduction of \$23,600, Credit for Small Employer Health Insurance Premiums of \$3,600, and nondeductible meals and entertainment expense of \$550, for a total of \$27,750.

**Line 7. Distributions other than dividend distributions.** Decrease AAA (but not below zero) by property distributions other than dividend distributions from accumulated Earnings and Profits (E&P), unless the corporation elects to reduce accumulated E&P first. See *Election to Distribute Earnings and Profits First*, page 19-11. In this example, the S corporation distributed \$10,000 to shareholders. See *Distributions*, page 19-18.

**Columns (b), Other adjustments account, and (c), Shareholder's undistributed taxable income previously taxed.** These columns are not used in this example. For more information on these columns, see *Distributions*, page 19-10.

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**Schedule K Shareholders' Pro Rata Share Items**

1	Ordinary business income (loss) (page 1, line 21)		1	79,892
2	Net rental real estate income (loss) (attach Form 8825)		2	
3a	Other gross rental income (loss)		3a	
3b	Expenses from other rental activities (attach statement)		3b	
3c	Other net rental income (loss). Subtract line 3b from line 3a		3c	
4	Interest income		4	566
5	Dividends: a Ordinary dividends b Qualified dividends		5a	
6	Royalties		5b	
7	Net short-term capital gain (loss) (attach Schedule D (Form 1120S))		6	
8a	Net long-term capital gain (loss) (attach Schedule D (Form 1120S))		7	
8b	Collectibles (28%) gain (loss)		8a	
8c	Unrecaptured section 1250 gain (attach statement)		8b	
9	Net section 1231 gain (loss) (attach Form 4797)		8c	
10	Other income (loss) (see instructions)	Type ▶	9	
11	Section 179 deduction (attach Form 4562)		10	
12a	Charitable contributions		11	23,600
12b	Investment interest expense		12a	
12c(1)	Section 59(e)(2) expenditures (1) Type ▶	(2) Amount ▶	12b	
12d	Other deductions (see instructions)	Type ▶	12c(2)	
13a	Low-income housing credit (section 42(j)(5))		12d	
13b	Low-income housing credit (other)		13a	
13c	Qualified rehabilitation expenditures (rental real estate) (attach Form 3468, if applicable)		13b	
13d	Other rental real estate credits (see instructions) Type ▶		13c	
13e	Other rental credits (see instructions) Type ▶		13d	
13f	Biofuel producer credit (attach Form 6478) Type ▶		13e	
13g	Other credits (see instructions) Type ▶	Health Insurance Premiums	13f	
14a	Name of country or U.S. possession ▶		13g	3,600
14b	Gross income from all sources		14a	
14c	Gross income sourced at shareholder level		14b	
14d	Foreign gross income sourced at corporate level		14c	
14e	Passive category		14d	
14f	General category		14e	
14g	Other (attach statement)		14f	
14h	Deductions allocated and apportioned at shareholder level		14g	
14i	Interest expense		14h	
14j	Other information		14i	
14k	Deductions allocated and apportioned at corporate level to foreign source income		14j	
14l	Passive category		14k	
14m	General category		14l	
14n	Other (attach statement)		14m	
14o	Total foreign taxes (check one) ▶ <input type="checkbox"/> Paid <input type="checkbox"/> Accrued		14n	
14p	Reduction in taxes available for credit (attach statement)		14o	
14q	Other foreign tax information (attach statement)		14p	
15a	Post-1986 depreciation adjustment		14q	
15b	Adjusted gain or loss		15a	485
15c	Depletion (other than oil and gas)		15b	
15d	Oil, gas, and geothermal properties—gross income		15c	
15e	Oil, gas, and geothermal properties—deductions		15d	
15f	Other AMT items (attach statement)		15e	
15g	Other AMT items (attach statement)		15f	
16a	Tax-exempt interest income		15g	
16b	Other tax-exempt income		16a	
16c	Nondeductible expenses		16b	4,150
16d	Distributions (attach statement if required) (see instructions)		16c	10,000
16e	Repayment of loans from shareholders		16d	
16f			16e	

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**Schedule K Shareholders' Pro Rata Share Items (continued)**

17a	Investment income		17a	566
17b	Investment expenses		17b	
17c	Dividend distributions paid from accumulated earnings and profits		17c	
17d	Other items and amounts (attach statement)		17d	
18	Income/loss reconciliation. Combine the amounts on lines 1 through 10 in the far right column. From the result, subtract the sum of the amounts on lines 11 through 12d and 14l		18	56,858
<b>Schedule L Balance Sheets per Books</b>				
Assets				
1	Cash	(a)	(c)	(d)
2a	Trade notes and accounts receivable			142,117
2b	Less allowance for bad debts			
3	Inventories			9,100
4	U.S. government obligations			
5	Tax-exempt securities (see instructions)			
6	Other current assets (attach statement)			
7	Loans to shareholders			
8	Mortgage and real estate loans			
9	Other investments (attach statement)			
10a	Buildings and other depreciable assets			40,115
10b	Less accumulated depreciation			25,537
11a	Depreciable assets			14,578
11b	Less accumulated depreciation			
12	Land (net of any amortization)			
13a	Intangible assets (amortizable only)			
13b	Less accumulated amortization			
14	Other assets (attach statement)			
15	Total assets			165,795
Liabilities and Shareholders' Equity				
16	Accounts payable			
17	Mortgages, notes, bonds payable in less than 1 year			
18	Other current liabilities (attach statement)			2,618
19	Loans from shareholders			
20	Mortgages, notes, bonds payable in 1 year or more			20,459
21	Other liabilities (attach statement)			
22	Capital stock			100,000
23	Additional paid-in capital			
24	Retained earnings			42,708
25	Adjustments to shareholders' equity (attach statement)			
26	Less cost of treasury stock			
27	Total liabilities and shareholders' equity			165,785

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**Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return**

Note: The corporation may be required to file Schedule M-3 (see instructions)

1	Net income (loss) per books	52,708	5	Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize):
2	Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize)		a	Tax-exempt interest \$
3	Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 14, not charged against book income this year (itemize):		6	Deductions included on Schedule K, lines 1 through 12 and 14, not charged against book income this year (itemize):
a	Depreciation \$		a	Depreciation \$
b	Travel and entertainment \$	550	7	Salaries and wages \$
c	Salaries and wages \$	3,600	8	Other adjustments (Schedule K, line 8), Line 4, less line 7
4	Adjustments to book income	4,150	8	Add lines 5 and 6
5	Net income (loss) per books	56,858	9	Shareholders' undistributed taxable income previously taxed
<b>Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (see instructions)</b>				
(a) Accumulated adjustments account				
1	Balance at beginning of tax year	0	(b) Other adjustments account	
2	Ordinary income from page 1, line 21	79,892		
3	Other additions	566		
4	Loss from page 1, line 21			
5	Other reductions	(27,750)		
6	Combine lines 1 through 5	52,708		
7	Distributions other than dividend distributions	10,000		
8	Balance at end of tax year. Subtract line 7 from line 6	42,708		

671113  
OMB No. 1545-0123

**Schedule K-1 (Form 1120S)**  
Department of the Treasury  
Internal Revenue Service

For calendar year 2015, or tax year beginning 4/1/2015 ending 12/31/2015

**Shareholder's Share of Income, Deductions, Credits, etc.** ▶ See back of form and separate instructions.

**Part I Information About the Corporation**

A Corporation's employer identification number  
31-2345678

B Corporation's name, address, city, state, and ZIP code  
Greener Pastures, Inc.  
123 Prairie Point  
Farmdale, MN 55555

C IRS Center where corporation filed return  
e-file

**Part II Information About the Shareholder**

D Shareholder's identifying number  
XXX-XX-XXXX

E Shareholder's name, address, city, state, and ZIP code

F Shareholder's percentage of stock ownership for tax year 55%

**Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items**

1	Ordinary business income (loss)	43,941	13 Credits	P* \$1,980
2	Net rental real estate income (loss)			Employer Health Insurance Premiums
3	Other net rental income (loss)			
4	Interest income	311		
5a	Ordinary dividends			
5b	Qualified dividends			14 Foreign transactions
6	Royalties			
7	Net short-term capital gain (loss)			
8a	Net long-term capital gain (loss)			
8b	Collectibles (28%) gain (loss)			
8c	Unrecaptured section 1250 gain			
9	Net section 1231 gain (loss)			
10	Other income (loss)			15 Alternative minimum tax (AMT) items
				A** \$267
11	Section 179 deduction	12,980		16 Items affecting shareholder basis
12	Other deductions			C \$2,283 ***
				D \$5,500
				17 Other information
				A \$311
				V \$3,300
				RSA contribution
				V \$1,800 Health insurance premium (both included in W-2 income)

\* See attached statement for additional information.

For Paperwork Reduction Act Notice, see Instructions for Form 1120S. IRS.gov/form1120S Cat. No. 11520D Schedule K-1 (Form 1120S) 2015

\*\* See S Corporation K-1 Codes, page 7-3, 1040 Edition/Deluxe Edition.  
\*\*\* Nondeductible expenses consist of:  
Nondeductible portion of meals and entertainment ..... \$ 303  
Nondeductible portion of salaries and wages ..... \$1,980  
\$2,283

Attachment Sequence No. 13 Page 2

Schedule E (Form 1040) 2015  
Name(s) shown on return. Do not enter name and social security number if shown on other side.

**Note** Your social security number  
XXX-XX-XXXX

**Caution.** The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

**Part II Income or Loss From Partnerships and S Corporations** Note: If you report a loss from an at-risk activity for which any amount is not at risk, you must check the box in column (e) on line 28 and attach Form 6198. See instructions.

27 Are you reporting any loss not allowed in a prior year due to the at-risk, excess farm loss, or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section.  Yes  No

28

A	Greener Pastures, Inc.	(e) Name	(b) Enter P for partnership, S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if any amount is not at risk
B			S		31-2345678	
C						
D						

**Part III Income or Loss From Estates and Trusts**

A		(f) Passive loss allowed (attach Form 6582 if required)	(g) Passive income from Schedule K-1	(h) Nonpassive loss from Schedule K-1	(i) Section 179 expense deduction from Form 4582	(j) Nonpassive income from Schedule K-1
B					12,980	43,941
C						
D						
29a	Totals				12,980	
b	Totals					
30	Add columns (g) and (i) of line 29a					30 43,941
31	Add columns (f), (h), and (i) of line 29b					31 ( 12,980 )
32	Total partnership and S corporation income or (loss). Combine lines 30 and 31. Enter the result here and include in the total on line 41 below					32 30,961

**Part IV Income or Loss From Estates and Trusts**

A		(a) Name	(b) Employer identification number
B			

**Passive Income and Loss**

(a) Passive deduction or loss allowed (attach Form 6582 if required)	(d) Passive income from Schedule K-1	(e) Deduction or loss from Schedule K-1	(f) Other income from Schedule K-1

34a Totals

35 Add columns (c) and (f) of line 34a

36 Add columns (c) and (e) of line 34b

37 Total estate and trust income or (loss). Combine lines 35 and 36. Enter the result here and include in the total on line 41 below

**Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder**

38	(a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules O, line 2c (see instructions)	(d) Taxable income (net loss) from Schedules O, line 1b	(e) Income from Schedules O, line 3b
39					

**Part V Summary**

40 Net farm rental income or (loss) from Form 4885. Also, complete line 42 below

41 Total income or (loss). Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Form 1040, line 17, or Form 1040NR, line 18

42 Reconciliation of farming and fishing income. Enter your gross farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), box 14, code B; Schedule K-1 (Form 1120S), box 17, code V; and Schedule K-1 (Form 1041), box 14, code F (see instructions)

43 Reconciliation for real estate professionals. If you were a real estate professional (see instructions), enter the net income or (loss) you reported anywhere on Form 1040 or Form 1040NR from all rental real estate activities in which you materially participated under the passive activity loss rules

Department of the Treasury - Internal Revenue Service (99) OMB No. 1545-0074 IRS Use Only - Do not write or staple in this space.

# 1040 U.S. Individual Income Tax Return 2015

For the year Jan. 1-Dec. 31, 2015, or other tax year beginning . . . . . 2015, ending . . . . . 20

Your first name and initial **Name** Last name Last name

If a joint return, spouse's first name and initial . . . . .

Home address (number and street). If you have a P.O. box, see instructions. . . . . Apt. no. . . . .

City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).

Foreign country name Foreign province/state/country Foreign postal code

**Filing Status**

1  Single  
 2  Married filing jointly (even if only one had income)  
 3  Married filing separately. Enter spouse's SSN above and full name here: ▶

**Exemptions**

6a  Yourself. If someone can claim you as a dependent, do not check box 6a.  
 b  Spouse  
 c Dependents: (1) First name Last name (2) Dependent's social security number (3) Dependent's relationship to you (4) If child under age 17, did not live with you (see instructions) (5) Qualifying widow(er) with dependent child

If more than four dependents, see instructions and check here ▶

**Income**

7 Wages, salaries, tips, etc. Attach Form(s) W-2 . . . . . 7 **55,405**  
 8a Tax-exempt interest. Attach Schedule B if required . . . . . 8a **311**  
 9a Ordinary dividends. Attach Schedule B if required . . . . . 9a  
 b Qualified dividends . . . . . 9b  
 10 Taxable refunds, credits, or offsets of state and local income taxes . . . . . 10  
 11 Alimony received . . . . . 11  
 12 Business income or (loss). Attach Schedule C or C-EZ . . . . . 12  
 13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶   
 14 Other gains or (losses). Attach Form 4797 . . . . . 14  
 15a IRA distributions . . . . . 15a  
 16a Pensions and annuities . . . . . 16a  
 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E . . . . . 17  
 18 Farm income or (loss). Attach Schedule F . . . . . 18  
 19 Unemployment compensation . . . . . 19  
 20a Social security benefits . . . . . 20a  
 21 Other income. List type and amount . . . . . 21  
 22 Combine the amounts in the far right column for lines 7 through 21. This is your total income . . . . . 22 **86,677**

23 Reserved . . . . . 23  
 24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ . . . . . 24  
 25 Health savings account deduction. Attach Form 8889 . . . . . 25 **3,350**  
 26 Moving expenses. Attach Form 3903 . . . . . 26  
 27 Deductible part of self-employment tax. Attach Schedule SE . . . . . 27  
 28 Self-employed SEP, SIMPLE, and qualified plans . . . . . 28 **1,800**  
 29 Self-employed health insurance deduction . . . . . 29  
 30 Penalty on early withdrawal of savings . . . . . 30  
 31a Alimony paid b Recipient's SSN ▶ . . . . . 31a  
 32 IRA deduction . . . . . 32  
 33 Student loan interest deduction . . . . . 33  
 34 Reserved . . . . . 34  
 35 Domestic production activities deduction. Attach Form 8803 . . . . . 35  
 36 Add lines 23 through 35 . . . . . 36 **5,150**  
 37 Subtract line 36 from line 22. This is your adjusted gross income . . . . . 37 **81,527**

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form 1040 (2015)

Form 1040 (2015) Page 2

**Tax and Credits**

38 Amount from line 37 (adjusted gross income) . . . . . **81,527**  
 39a Check  You were born before January 2, 1951.  Blind.  Total boxes  
 if:  Spouse was born before January 2, 1951.  Blind.  checked ▶ 39a  
 b If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b

**Standard Deduction**

40 Subtract line 40 from line 38 . . . . . **6,300**  
 41  People who check any box on line 39a or 39b or a claimed as a dependent. See instructions. . . . . **75,227**  
 42  All others. See instructions. . . . . **4,000**  
 43  Married filing separately, \$6,300 . . . . . **71,227**  
 44  Married filing jointly or qualifying widow(er), \$12,600 . . . . . **13,600**  
 45  Head of household, \$9,250 . . . . . **46**  
 46 Excess advance premium tax credit repayment. Attach Form 8962 . . . . . **47**  
 47 Foreign tax credit. Attach Form 1116 if required . . . . . **48**  
 48 Foreign tax credit. Attach Form 1116 if required . . . . . **49**  
 49 Credit for child and dependent care expenses. Attach Form 2441 . . . . . **50**  
 50 Education credits from Form 8863, line 19 . . . . . **51**  
 51 Retirement savings contributions credit. Attach Form 8880 . . . . . **52**  
 52 Child tax credit. Attach Schedule 8812, if required. . . . . **53**  
 53 Residential energy credit. Attach Form 5695 . . . . . **54**  
 54 Other credits from Form: a  3800 b  8801 c  1,980 . . . . . **55**  
 55 Add lines 48 through 54. These are your total credits . . . . . **11,620**  
 56 Subtract line 55 from line 47. If line 55 is more than line 47, enter -0- . . . . . **57**

**Other Taxes**

57 Self-employment tax. Attach Schedule SE . . . . . **58**  
 58 Unreported social security and Medicare tax from Form: a  4137 b  8919 . . . . . **59**  
 59 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required . . . . . **60a**  
 60a Household employment taxes from Schedule H . . . . . **60b**  
 61 First-time homebuyer credit repayment. Attach Form 5405 if required . . . . . **61**  
 62 Health care: individual responsibility (see instructions) Full-year coverage  . . . . . **62**  
 63 Taxes from Form: a  Form 9859 b  Form 9860 c  Instructions; enter code(s) . . . . . **63**  
 64 Add lines 56 through 62. This is your total tax . . . . . **64**  
 65 Federal income tax withheld from Forms W-2 and 1099 . . . . . **65**  
 65 2015 estimated tax payments and amount applied for 2014 return . . . . . **65**  
 66a **Earned income credit (EIC)** . . . . . **66a**  
 66b Nontaxable combat pay election . . . . . **66b**  
 67 Additional child tax credit. Attach Schedule 8812 . . . . . **67**  
 68 American opportunity credit from Form 8863, line 8 . . . . . **68**  
 69 Net premium tax credit. Attach Form 8962 . . . . . **69**  
 70 Amount paid with request for extension to file . . . . . **70**  
 71 Excess social security and tier 1 RRTA tax withheld . . . . . **71**  
 72 Credit for federal tax on fuels. Attach Form 4136 . . . . . **72**  
 73 Credits from Form: a  2439 b  8885 c  8885 d  73 . . . . . **73**  
 74 Add lines 64, 65, 66a, and 67 through 73. These are your total payments . . . . . **74**  
 75 If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you overpaid . . . . . **75**  
 76a Amount of line 75 you want refunded to you. If Form 8888 is attached, check here  ▶ **76a**

**Payments**

64 Federal income tax withheld from Forms W-2 and 1099 . . . . . **64**  
 65 2015 estimated tax payments and amount applied for 2014 return . . . . . **65**  
 66a **Earned income credit (EIC)** . . . . . **66a**  
 66b Nontaxable combat pay election . . . . . **66b**  
 67 Additional child tax credit. Attach Schedule 8812 . . . . . **67**  
 68 American opportunity credit from Form 8863, line 8 . . . . . **68**  
 69 Net premium tax credit. Attach Form 8962 . . . . . **69**  
 70 Amount paid with request for extension to file . . . . . **70**  
 71 Excess social security and tier 1 RRTA tax withheld . . . . . **71**  
 72 Credit for federal tax on fuels. Attach Form 4136 . . . . . **72**  
 73 Credits from Form: a  2439 b  8885 c  8885 d  73 . . . . . **73**  
 74 Add lines 64, 65, 66a, and 67 through 73. These are your total payments . . . . . **74**  
 75 If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you overpaid . . . . . **75**  
 76a Amount of line 75 you want refunded to you. If Form 8888 is attached, check here  ▶ **76a**

**Refund**

76a Amount of line 75 you want refunded to you. If Form 8888 is attached, check here  ▶ **76a**

Direct deposit?  a Routing number  b Account number  c Type:  Checking  Savings

See instructions. ▶ d Amount of line 75 you want applied to your 2016 estimated tax ▶ **77**

**You Owe**

77 Amount of line 75 you want applied to your 2016 estimated tax ▶ **77**

**Amount You Owe**

78 Amount you owe. Subtract line 74 from line 63. For details on how to pay, see instructions ▶ **78**  
 79 Estimated tax penalty (see instructions) . . . . . ▶ **79**

**Third Party Designee**

Do you want to allow another person to discuss this return with the IRS (see instructions)?  Yes. Complete below.  No  
 Designee's name ▶ Phone number ▶ Personal identification number (PIN) ▶

**Sign Here**

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.  
 Your signature ▶ Date ▶ Your occupation ▶ Daytime phone number ▶  
 Spouse's signature. If a joint return, both must sign. ▶ Date ▶ Spouse's occupation ▶  
 Preparer's signature ▶ Date ▶  
 Preparer's name ▶ Firm's name ▶  
 Firm's address ▶ Firm's EIN ▶  
 Phone no. ▶

www.irs.gov/form1040 Form 1040 (2015)

**Form 3800** Department of the Treasury Internal Revenue Service (99) Name(s) shown on return

OMB No. 1545-0095  
**2015** Attachment Sequence No. 22  
Information about Form 3800 and its separate instructions is at [www.irs.gov/form3800](http://www.irs.gov/form3800). You must attach all pages of Form 3800, pages 1, 2, and 3, to your tax return.

**Part I Current Year Credit for Credits Not Allowed Against Tentative Minimum Tax (TMT)**  
(See instructions and complete Part(s) III before Parts I and II)

1	General business credit from line 2 of all Parts III with box A checked	1
2	Passive activity credits from line 2 of all Parts III with box B checked	2
3	Enter the applicable passive activity credits allowed for 2015 (see instructions)	3
4	Carryforward of general business credit to 2015. Enter the amount from line 2 of Part III with box C checked. See instructions for statement to attach	4
5	Carryback of general business credit from 2016. Enter the amount from line 2 of Part III with box D checked (see instructions)	5
6	Add lines 1, 3, 4, and 5	6

**Part II Allowable Credit**

Regular tax before credits:

- Individuals. Enter the sum of the amounts from Form 1040, lines 44 and 46, or the sum of the amounts from Form 1040NR, lines 42 and 44
- Corporations. Enter the amount from Form 1120, Schedule J, Part I, line 2; or the applicable line of your return
- Estates and trusts. Enter the sum of the amounts from Form 1041, Schedule G, lines 1a and 1b; or the amount from the applicable line of your return

Alternative minimum tax:

- Individuals. Enter the amount from Form 6251, line 35
- Corporations. Enter the amount from Form 4626, line 14
- Estates and trusts. Enter the amount from Schedule I (Form 1041), line 56

7	Add lines 7 and 8	7	13,600
8	Foreign tax credit	8	
9	Certain allowable credits (see instructions)	9	13,600
10a	Add lines 7 and 8	10a	
10b	Foreign tax credit	10b	
10c	Add lines 10a and 10b	10c	
11	Net income tax. Subtract line 10c from line 9. If zero, skip lines 12 through 15 and enter -0- on line 16	11	13,600
12	Net regular tax. Subtract line 10c from line 7. If zero or less, enter -0-	12	13,600
13	Enter 25% (.25) of the excess, if any, of line 12 over \$25,000 (see instructions)	13	
14	Tentative minimum tax	14	
15	Enter the greater of line 13 or line 14	15	
16	Subtract line 15 from line 11. If zero or less, enter -0-	16	13,600
17	Enter the smaller of line 6 or line 16	17	0

**Part III General Business Credit**  
Information about Form 3800 and its separate instructions is at [www.irs.gov/form3800](http://www.irs.gov/form3800). You must attach all pages of Form 3800, pages 1, 2, and 3, to your tax return.

Identifying number: xxx-xx-xxx1

**Part III General Business Credits or Eligible Small Business Credits** (see instructions)  
Complete a separate Part III for each box checked below. (see instructions)

General Business Credit From a Non-Passive Activity  
 General Business Credit From a Passive Activity  
 General Business Credit Carryforwards  
 General Business Credit Carrybacks

Eligible Small Business Credit  
 Eligible Small Business Credit Carryforwards  
 Eligible Small Business Credit Carrybacks

If you are filing more than one Part III with box A or B checked, complete and attach first an additional Part III combining amounts from all Parts III with box A or B checked. Check here if this is the consolidated Part III.

Small employer health insurance premiums (Form 8941)

4h	31-2345678	1,980
4i		
4j		
4k		
4l		
4m		
4n		
4o		
4p		
4q		
4r		
4s		
4t		
4u		
4v		
4w		
4x		
4y		
4z		
5	Add lines 4a through 4z and enter here and on the applicable line of Part II.	1,980
6	Add lines 2, 3, and 5 and enter here and on the applicable line of Part II.	1,980

Form 3800 (2015) **Part II Allowable Credit (Continued)**

Note: If you are not required to report any amounts on lines 22 or 24 below, skip lines 18 through 25 and enter -0- on line 26.

18	Multiply line 14 by 75% (.75) (see instructions)	18	
19	Enter the greater of line 13 or line 18	19	
20	Subtract line 19 from line 11. If zero or less, enter -0-	20	13,600
21	Subtract line 17 from line 20. If zero or less, enter -0-	21	13,600
22	Combine the amounts from line 3 of all Parts III with box A, C, or D checked	22	
23	Passive activity credit from line 3 of all Parts III with box B checked	23	
24	Enter the applicable passive activity credit allowed for 2015 (see instructions)	24	
25	Add lines 22 and 24	25	
26	Empowerment zone and renewal community employment credit allowed. Enter the smaller of line 21 or line 25	26	
27	Subtract line 13 from line 11. If zero or less, enter -0-	27	13,600
28	Add lines 17 and 26	28	
29	Subtract line 28 from line 27. If zero or less, enter -0-	29	13,600
30	Enter the general business credit from line 5 of all Parts III with box A checked	30	1,980
31	Reserved	31	
32	Passive activity credits from line 5 of all Parts III with box B checked	32	
33	Enter the applicable passive activity credits allowed for 2015 (see instructions)	33	
34	Carryforward of business credit to 2015. Enter the amount from line 5 of Part III with box C checked and line 6 of Part III with box G checked. See instructions for statement to attach	34	
35	Carryback of business credit from 2016. Enter the amount from line 5 of Part III with box D checked (see instructions)	35	
36	Add lines 30, 33, 34, and 35	36	1,980
37	Enter the smaller of line 29 or line 36	37	1,980
38	Credit allowed for the current year. Add lines 28 and 37. Report the amount from line 38 (if smaller than the sum of Part I, line 6, and Part II, lines 25 and 36, see instructions) as indicated below or on the applicable line of your return: • Individuals. Form 1040, line 54, or Form 1040NR, line 51 • Corporations. Form 1120, Schedule J, Part I, line 5c • Estates and trusts. Form 1041, Schedule G, line 2b	38	1,980

Form 3800 (2015) **Part III General Business Credits or Eligible Small Business Credits** (see instructions)  
Complete a separate Part III for each box checked below. (see instructions)

General Business Credit From a Non-Passive Activity  
 General Business Credit From a Passive Activity  
 General Business Credit Carryforwards  
 General Business Credit Carrybacks

Eligible Small Business Credit  
 Eligible Small Business Credit Carryforwards  
 Eligible Small Business Credit Carrybacks

If you are filing more than one Part III with box A or B checked, complete and attach first an additional Part III combining amounts from all Parts III with box A or B checked. Check here if this is the consolidated Part III.

Small employer health insurance premiums (Form 8941)

4h	31-2345678	1,980
4i		
4j		
4k		
4l		
4m		
4n		
4o		
4p		
4q		
4r		
4s		
4t		
4u		
4v		
4w		
4x		
4y		
4z		
5	Add lines 4a through 4z and enter here and on the applicable line of Part II.	1,980
6	Add lines 2, 3, and 5 and enter here and on the applicable line of Part II.	1,980