

# 19 S Corporations

## ■ Tab 19 Contents ■

Where to File . . . . .	19-1
Electronic Filing . . . . .	19-1
Common Elections . . . . .	19-1
Filing Requirements . . . . .	19-1
Filing Deadline . . . . .	19-1
Amended Form 1120-S . . . . .	19-1
Business Activity Codes . . . . .	19-1
Schedule K-1 Codes (Form 1120-S)—S Corporation . . . . .	19-2
Foreign Transactions Reporting . . . . .	19-2
S Corporation Advantages/Disadvantages . . . . .	19-3
Penalties . . . . .	19-3
Taxation Summary—Corporations and Partnerships . . . . .	19-3
Basics of S Corporations . . . . .	19-3
S Corporation Formation . . . . .	19-3
S Corporation Qualifications . . . . .	19-4
One-Class-of-Stock Rule . . . . .	19-5
Form 2553, <i>Election by a Small Business Corporation</i> . . . . .	19-5
Relief for Late S Corporation Elections . . . . .	19-5
Resolving Frequently Encountered S Corporation Issues . . . . .	19-6
Termination of S Corporation Status . . . . .	19-7
Inadvertent Termination . . . . .	19-7
Treatment of S Corporation Termination Year . . . . .	19-7
Pass-Through to S Corporation Shareholders . . . . .	19-8
Pro Rata Allocation/Per-Share/Per-Day . . . . .	19-8
Separately Stated S Corporation Items . . . . .	19-8
Schedules K-2 and K-3 (Form 1120-S) . . . . .	19-9
Shareholder Basis . . . . .	19-9
S Corporation Shareholder's Basis . . . . .	19-9
Loans . . . . .	19-11
Discharge of Indebtedness . . . . .	19-12
Distributions . . . . .	19-12
Accumulated Adjustments Account (AAA) . . . . .	19-12
Ordering Rules . . . . .	19-12
Election to Distribute Earnings and Profits (E&P) First . . . . .	19-13
S Corporation Liquidation . . . . .	19-13
S Corporation Taxes . . . . .	19-13
Excess Net Passive Income Tax (IRC §1375) . . . . .	19-14
Built-In Gains (BIG) Tax . . . . .	19-14
Miscellaneous S Corporation Issues . . . . .	19-15
Required Tax Year for S Corporations and PSCs . . . . .	19-15
Employee Business Expense for S Corporation Shareholder . . . . .	19-16
Reasonable Compensation . . . . .	19-16
Fringe Benefits for S Corporation Shareholders . . . . .	19-16
No Carryovers Between C and S Year . . . . .	19-17
S Corporation Example . . . . .	19-17
Health Savings Accounts . . . . .	19-19
SIMPLE plan . . . . .	19-19

### Where to File

For Form 1120-S filing addresses, see *2025 Where to File Business Returns*, page 24-1.

### Electronic Filing

S corporations can generally e-file Form 1120-S 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. Returns for the current tax year, as well as two prior years, may be e-filed. See *Electronic Filing*, page 18-2.

## ■ New for 2025 ■

- **Excess business loss limitation.** The excess business loss limitation has been made permanent. See *Limitation on losses*, page 19-9.

### Common Elections

- Election to be taxed as an S corporation, page 19-5.
- Election to close books on date of S corporation election termination, page 19-7.
- Election to allocate pass-through items based on two short years, page 19-8.
- Election to switch order of basis adjustments, page 19-10.
- Election to distribute earnings and profits (E&P) first, page 19-13.
- Election other than required taxable year (IRC §444), page 19-15.

### Filing Requirements

**Form 1120-S.** A corporation or other entity must file Form 1120-S if it elected to be an S corporation by filing Form 2553, the IRS accepted the election, and the election remains in effect. Do not file Form 1120-S for any tax year before the year the election takes effect.

**Relief for late elections.** If the entity has not filed Form 2553, or did not file Form 2553 on time, it may be entitled to relief for a late filed election to be an S corporation. See *Relief for Late S Corporation Elections*, page 19-5.

### Filing Deadline

Form 1120-S 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 1120-S 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 1120-S), 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 *2025 Where to File Business Returns*, page 24-1.

### Amended Form 1120-S

File an amended S corporation tax return using Form 1120-S. 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. Amended returns may be filed electronically.

### Business Activity Codes

See *Principal Business or Professional Activity Codes for Corporations and Partnerships*, page 25-6.

# Schedule K-1 Codes (Form 1120-S)— S Corporation

**Note:** The 2025 Schedule K-1 (Form 1120-S) codes were not available at the time this publication went to print. Listed below are the 2024 Schedule K-1 (Form 1120-S) codes.

**List of Codes.** This list identifies the codes used on Schedule K-1 for all shareholders. For detailed reporting and filing information, see the specific line instructions, and the instructions for the taxpayer's income tax return.

Box 10. Other income (loss)	
Code	
A	Other portfolio income (loss)
B	Involuntary conversions
C	Section 1256 contracts and straddles
D	Mining exploration costs recapture
E	Section 951A(a) income inclusions
F	Inclusions of subpart F income
G	Section 951(a)(1)(B) inclusions
H	Reserved for future use
I	Gain (loss) from disposition of oil, gas, geothermal, or other mineral properties
J	Recoveries of tax benefit items
K	Gambling gains and losses
L	Reserved for future use
M	Gain eligible for section 1045 rollover (replacement stock purchased by the corporation)
N	Gain eligible for section 1045 rollover (replacement stock not purchased by the corporation)
O	Sale or exchange of QSB stock with section 1202 exclusion
P – R	Reserved for future use
S	Non-portfolio capital gain (loss)
T – X	Reserved for future use
ZZ	Other income (loss)
Box 12. Other deductions	
A	Cash contributions (60%)
B	Cash contributions (30%)
C	Noncash contributions (50%)
D	Noncash contributions (30%)
E	Capital gain property to a 50% limit organization (30%)
F	Capital gain property (20%)
G	Contributions (100%)
H	Investment interest expense
I	Deductions—Royalty income
J	Section 59(e)(2) expenditures
K	Reserved for future use
L	Deductions—Portfolio income (other)
M	Preproductive period expenses
N	Reserved for future use
O	Reforestation expense deduction
P – V	Reserved for future use
W	Soil and water conservation
X	Film, television, and theatrical production expenditures
Y	Expenditures for removal of barriers
Z	Itemized deductions
AA	Contributions to a capital construction fund (CCF)
AB	Penalty on early withdrawal of savings
AC	Interest expense allocated to debt financed distributions
AD – AJ	Reserved for future use
ZZ	Other deductions

Box 13. Credits	
A	Zero-emission nuclear power production credit
B	Credit for production from advanced nuclear power facilities
C	Low-income housing credit (section 42(j)(5)) from post-2007 buildings
D	Low-income housing credit (other) from post-2007 buildings
E	Qualified rehabilitation expenditures (rental real estate)
F	Other rental real estate credits
G	Other rental credits
H	Undistributed capital gains credit
I	Biofuel producer credit
J	Work opportunity credit
K	Disabled access credit
L	Empowerment zone employment credit
M	Credit for increasing research activities
N	Credit for employer social security and Medicare taxes
O	Backup withholding
P	Unused investment credit from the qualifying advanced coal project credit or qualifying gasification project credit allocated from cooperatives
Q	Unused investment credit from the qualifying advanced energy project credit allocated from cooperatives
R	Unused investment credit from the advanced manufacturing investment credit allocated from cooperatives
S	Unused investment credit from clean electricity credit allocated from cooperatives
T	Unused investment credit from the energy credit allocated from cooperatives
U	Unused investment credit from the rehabilitation credit allocated from cooperatives
V	Advanced manufacturing production credit
W	Clean electricity production credit
X	Clean fuel production credit
Y	Clean hydrogen production credit
Z	Orphan drug credit
AA	Enhanced oil recovery credit
AB	Renewable electricity production credit
AC	Biodiesel, renewable diesel, or sustainable aviation fuels credit
AD	New markets credit
AE	Credit for small employer pension plan startup costs
AF	Credit for small employer auto-enrollment
AG	Credit for military spouse participation
AH	Credit for employer-provided childcare facilities and services

Box 13. Credits continued	
AI	Low sulfur diesel fuel production credit
AJ	Qualified railroad track maintenance credit
AK	Credit for oil and gas production from marginal wells
AL	Distilled spirits credit
AM	Energy efficient home credit
AN	Reserved for future use
AO	Alternative fuel vehicle refueling property credit
AP	Clean renewable energy bond credit
AQ	New clean renewable energy bond credit
AR	Qualified energy conservation bond credit
AS	Qualified zone academy bond credit
AT	Qualified school construction bond credit
AU	Build America bond credit
AV	Credit for employer differential wage payments
AW	Carbon oxide sequestration credit
AX	Carbon oxide sequestration credit recapture
AY	New clean vehicle credit
AZ	Qualified commercial clean vehicle credit
BA	Credit for small employer health insurance premiums
BB	Employer credit for paid family and medical leave
BC	Eligible credits from transferor(s) under section 6418
BD – BG	Reserved for future use
ZZ	Other credits
Box 15. Alternative minimum tax (AMT) items	
A	Post-1986 depreciation adjustment
B	Adjusted gain or loss
C	Depletion (other than oil & gas)
D	Oil, gas, & geothermal—Gross income
E	Oil, gas, & geothermal—Deductions
F	Other AMT items
Box 16. Items affecting share-holder basis	
A	Tax-exempt interest income
B	Other tax-exempt income
C	Nondeductible expenses
D	Distributions
E	Repayment of loans from shareholders
F	Foreign taxes paid or accrued
Box 17. Other information	
A	Investment income

Box 17. Other information continued	
B	Investment expenses
C	Qualified rehabilitation expenditures (other than rental real estate)
D	Basis of energy property
E	Recapture of low-income housing credit [section 42(j) (5)]
F	Recapture of low-income housing credit (other)
G	Recapture of investment credit
H	Recapture of other credits
I	Look-back interest—Completed long-term contracts
J	Look-back interest—Income forecast method
K	Dispositions of property with section 179 deductions
L	Recapture of section 179 deduction
M	Section 453(l)(3) information
N	Section 453A(c) information
O	Section 1260(b) information
P	Interest allocable to production expenditures
Q	Capital construction fund (CCF) nonqualified withdrawals
R	Depletion information—Oil and gas
S – T	Reserved for future use
U	Net investment income
V	Section 199A information
W – Z	Reserved for future use
AA	Excess taxable income
AB	Excess business interest income
AC	Gross receipts for section 448(c)
AD – AI	Reserved for future use
AJ	Excess business loss limitation
AK – AM	Reserved for future use
AN	Farming and fishing income
AO	Reserved for future use
AP	Inversion gain
AQ – AR	Reserved for future use
AS	Qualifying advanced coal project property and qualifying gasification project property
AT	Qualifying advanced energy project property
AU	Advanced manufacturing investment property
AV	Clean electricity investment property
AW	Reportable transactions
AX – BD	Reserved for future use
ZZ	Other information

## Foreign Transactions Reporting

**Foreign income.** Schedule K-2 (Form 1120-S) is used to report items of international tax relevance from the operation of an S corporation. Schedule K-3 (Form 1120-S) is generally used to report to shareholders their shares of the items reported on Schedule K-2. See *Schedules K-2 and K-3 (Form 1120-S)*, page 19-9.

**Foreign assets.** Domestic corporations, partnerships, and trusts must file Form 8938, *Statement of Specified Foreign Financial Assets*, with their tax returns if the total value of assets was more than \$50,000 on the last day of the tax year, or more than \$75,000 at any time during the tax year. See *Foreign Accounts and Trusts*, page 6-4.

## 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 generally 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. See <i>Net Operating Loss (NOL)</i> , page 8-20.
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 19-16.

### 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 19-5.
Debt basis	An S corporation shareholder's basis does not increase by assuming liability on a loan unless it is a direct loan from the shareholder to the S corporation. See <i>Loans</i> , page 19-11.
Carryovers	Items such as net operating losses from C corporations are not allowed to be used in an S corporation year. See <i>No Carryovers Between C and S Year</i> , page 19-17.
All income taxed	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 Benefits</i> , Tab 22.

Also see the *Business Entity Comparison Chart*, page 27-3.

### Penalties (For returns required to be filed in 2026)

**Late filing.** For returns on which no tax is due, the penalty for late filing of an S corporation return is \$255 per month, or part of a 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 \$525.

**Late payment.** If any S corporation taxes are due, a late payment penalty of 0.5% of unpaid tax per month, or part of a month, applies up to a maximum of 25% of the unpaid tax.

**Schedule K-1 (Form 1120-S).** A \$340 penalty applies for each failure to timely issue Schedule K-1 (Form 1120-S) to a shareholder or failure to provide required information. The penalty may be increased if the failure is intentional. The penalties listed above may be waived for reasonable cause.

## Taxation Summary—Corporations and Partnerships<sup>1</sup>

	S Corporation	C Corporation	Partnership
<b>Taxation</b>	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.
<b>Income</b>	Business income from an S corporation is passed through to shareholders and taxed as ordinary income.	After-tax profits of a C corporation may be 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 partners and taxed as ordinary income. Guaranteed payments and general partners' share of income is subject to self-employment tax at the individual level.
<b>Losses</b>	Business losses passing through to an S corporation shareholder are treated as ordinary losses.	A C corporation does not pass losses through to shareholders. <sup>2</sup>	Business losses passing through to partners are treated as ordinary losses.
<b>Capital Gains and Losses</b>	Capital gains and losses pass through to shareholders as separately stated items on Schedule K-1 (Form 1120-S).	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 partners as separately stated items on Schedule K-1 (Form 1065).

<sup>1</sup> Also see the *Business Entity Comparison Chart*, page 27-3.

<sup>2</sup> See *Corporate Net Operating Loss (NOL)*, page 18-12.

## Basics of S Corporations

### Cross References

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

### Related Topics

- Business Deductions, Tab 8
- C Corporations, Tab 18
- Entity Classification Election, page 18-17
- Principal Business or Professional Activity Codes for Corporations and Partnerships, page 25-6
- Business Agreements, page 27-5

### 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 was formed under state law, or made the election to be taxed as a corporation, the entity must file Form 2553, to elect S corporation status. See *Form 2553, Election by a Small Business Corporation*, page 19-5.

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 1120-S, *U.S. Income Tax Return for*

an S Corporation, and passed through to shareholders, along with other tax items on Schedule K-1 (Form 1120-S).

**Did You Know?** The not-for-profit activity limitation of IRC section 183 applies to S corporations. See *Hobby Loss Rules*, page 5-21.

## 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 (and their estates) are treated as one shareholder. This includes family members up to six generations (and their estates). 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*, page 19-5.
- The corporation must be a domestic corporation. Individual shareholders must be citizens or residents of the United States.

Eligible Shareholders	Ineligible Shareholders
<ul style="list-style-type: none"> <li>• Individuals—U.S. citizens or residents.</li> <li>• Decedent's estates.</li> <li>• Bankruptcy estates.</li> <li>• IRC §501(c)(3) charitable organizations.</li> <li>• Qualified Subchapter S Trusts (QSSTs).</li> <li>• Electing Small Business Trusts (ESBTs).</li> <li>• Grantor trusts.</li> <li>• Testamentary trusts.</li> <li>• Employee stock ownership plans.</li> <li>• Qualified pension and profit-sharing plans [(IRC §1361(b)(1)(B)).</li> </ul>	<ul style="list-style-type: none"> <li>• Nonresident aliens.</li> <li>• Foreign trusts.</li> <li>• Most corporations.<sup>1</sup></li> <li>• Partnerships.</li> <li>• Charitable remainder trusts.</li> <li>• IRAs.</li> <li>• LLCs and LLPs. (Single-member LLCs treated as disregarded entities may own S corporation shares.)</li> </ul>

<sup>1</sup> See *Qualified Subchapter S Subsidiary (QSub)*, next column.

**Qualified Subchapter S Trust (QSST).** A QSST is permitted to hold stock in an S corporation [IRC §1361(d)]. 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 IRS Regulation section 1.1361-1(m)(2) for information about how to make the election.
- Potential current beneficiaries must also be eligible S corporation shareholders. **Exception:** A nonresident alien may be a potential current beneficiary [Reg. §1.1361-1(m)(1)(ii)(D)]. 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.

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 18-22.

**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:** Alpha Corporation, an S corporation, owns 100% of the stock of Beta Corporation, an S corporation for which a QSub election has been made. On January 10, 2025, Alpha sells 35% of Beta's stock to Charlie Corporation, an unrelated corporation. Beta terminates as a QSub. Alpha pays tax on the gain from the sale of 35% of Beta's stock and is treated as acquiring the remaining stock of Beta in a tax-free IRC section 351 exchange.

**Grantor trust.** A grantor trust owned by a U.S. citizen or resident is an eligible shareholder.

**Death of deemed owner.** A trust that was a grantor trust immediately before the death of the deemed owner and that continues in existence after the death of the deemed owner will be allowed to continue as a shareholder, but only for the 2-year period beginning on the day of the deemed owner's death. [Reg. §1.1361-1(h)(1)(ii)]

**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 (2009)]

## 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 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)

**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 must not at any time exceed \$10,000, must be treated as debt by the parties, and must be expected to be repaid within a reasonable time, 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 stock transfers with shareholder agreements, such as right of first refusal, so that one shareholder

cannot transfer any shares to an ineligible shareholder, whether or not intentional whether or not intentional.

## Form 2553, Election by a Small Business Corporation

Form 2553 is filed by a corporation or other eligible entity 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. For more information about entities eligible to elect to be taxed as corporations, see *Entity Classification Election*, page 18-17.

**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 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 19-6.

**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 timely file the election and has acted diligently to correct the mistake upon discovery of the failure,
- 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 19-6.

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 2025-1, 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 period the election was intended to be effective stating 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 for relief.** The corporation must file Form 2553 by either:

- Attaching the election to the current year Form 1120-S as long as the current year Form 1120-S is filed within the three years and 75 days rule. An extension of time to file Form 1120-S will not extend the due date for relief. Form 1120-S 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 1120-S as long as the form is filed within the three years and 75 days rule and all other delinquent Forms 1120-S are filed simultaneously and consistent with the requested relief. Form 1120-S must state at the top *“INCLUDES LATE ELECTION(S) FILED PURSUANT TO REV. PROC. 2013-30.”*
- File Form 2553 independent of Form 1120-S 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 19-5.

**Late entity 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 an S 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 an 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 1120-S for the first year was timely filed, and

- The completed Form 2553 includes all the state ments as described in Revenue Procedure 2013-30.

## Resolving Frequently Encountered S Corporation Issues

Revenue Procedure 2022-19 allows S Corporations and their shareholders to resolve frequently encountered issues with certainty and without requesting a private letter ruling (PLR). The IRS lists six issues identified as not affecting the validity or continuation of an S corporation election. (Rev. Proc. 2022-19)

### Resolving Frequently Encountered S Corporation Issues

Issue	Description	Corrective Action
Disproportionate S corporation distributions	One-class-of-stock rule is not violated by making disproportionate distributions if governing provisions provide for identical distribution and liquidation rights.	No corrective action required with IRS if governing provisions provide for identical distribution and liquidation rights. IRS will not issue PLR.
Errors and omissions on Form 2553, <i>Election by a Small Business Corporation</i> , or Form 8869, <i>Qualified Subchapter S Subsidiary Election</i>	<ul style="list-style-type: none"> <li>• Form 2553 fails to include consent of a shareholder.</li> <li>• Form 2553 contains an error regarding a permitted year.</li> <li>• Missing signature on Form 2553 or Form 8869.</li> <li>• Any other error or omission on Form 2553 or Form 8869 not listed above.</li> </ul>	<ul style="list-style-type: none"> <li>• Request extension of time to file at IRS Service Center.</li> <li>• Request relief under other guidelines. See <i>Relief for Late S Corporation Elections</i>, page 19-5.</li> <li>• Submit written explanation to the IRS. See <i>Mailing address</i>, below.</li> <li>• If previous options are unsuccessful, request PLR.</li> </ul>
Non-identical governing provisions that violate one-class-of-stock rule	Retroactive correction of non-identical governing provisions is needed to prevent S election termination.	<ul style="list-style-type: none"> <li>• Eligible corporations may submit a Corporate Governing Provision Statement to IRS as detailed in Rev. Proc. 2022-19.</li> <li>• Request PLR if eligibility is not met.</li> </ul>
One-class-of-stock rule and the principal purpose requirement	Certain types of corporate agreements or arrangements do not violate the one-class-of-stock rule, as long as circumvention of the rule was not the principal purpose of the agreement or arrangement.	No corrective action required with the IRS if the principal purpose requirement is met. IRS will not issue PLR.
Tax filing inconsistent with S election	An S corporation or parent S corporation of a QSub filed tax returns inconsistent with S corporation status.	File appropriate tax returns for any open tax years.
Verification of S election or QSub election	Taxpayer is lacking written acknowledgement from the IRS of S election or QSub election.	Request replacement letter from IRS at 800-829-4933 (taxpayer) or 866-860-4259 (practitioner).

**Mailing address.** For errors and omissions on Form 2553 or Form 8869, a correction may be requested by submitting a written explanation of the errors/omissions and necessary corrections to the IRS. Mail the explanation to one of the following addresses, depending on where the S corporation files its tax return.

- Internal Revenue Service, MS 6055, 333 W. Pershing Rd., Kansas City, MO, 64108
- Internal Revenue Service, MS 6273, 1973 N. Rulon White Blvd., Ogden, UT 84404

## Termination of S Corporation Status

### Cross References

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

### Related Topics

- Corporate Liquidations, page 18-22
- Sale of a Business, page 28-2

### 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 accumulated 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 1120-S, 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 consent statement signed by the shareholder, under penalty of perjury, must include:

- 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. [Reg. §1.1362-6(b)]

**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 3-year period. [IRC §1362(d)(3)]

For purposes of this provision, passive income includes income from royalties, rents, dividends, interest, annuities, and gains from the sales or exchanges of stock or securities. 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 (IRC §1375)*, page 19-14.

**Planning Tip:** An S corporation that earns passive income and has accumulated earnings 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 19-13.

### 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)

### 5-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 5-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. [Reg. §1.1362-3(a)]

**Example #1:** Card Corporation, a calendar year corporation, begins 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	

**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.

**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)]

**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.

# Pass-Through to S Corporation Shareholders

## Cross References

- Schedule K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.*
- Schedule K-3 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc. – International.*
- IRC §1366, *Pass-thru of items to shareholders*

## Related Topics

- Self-employed health insurance deduction, page 5-10
- Passive Activity Losses, page 7-7
- At-Risk Rules, page 7-12
- Business Deductions, Tab 8
- Retirement, Social Security, and Medicare, Tab 13

## Ordinary Business Income

Ordinary business income or loss for an S corporation is netted and reported on line 22, page 1, Form 1120-S. 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 1120-S), and the amounts are reported on the shareholders' income tax returns.

Other items pass through to shareholders as separately stated items. See *Separately Stated S Corporation Items*, next column.

**Business interest expense limitation.** The business interest expense deduction may be limited for certain taxpayers, unless an exception is met. The rules that apply to S corporations and their shareholders are similar to partnerships and their partners. S corporation differences are noted below. See *Business Interest Expense Limitation*, page 20-9.

**Carryforward of disallowed expense.** The business interest limitation is applied at the S corporation level. Disallowed business interest expense is carried over by the S corporation and treated as business interest expense paid or accrued in the following year.

**Shareholders.** A shareholder subject to the limitation includes the following amounts from each of its S corporations:

- Current year excess taxable income, and
- Current year excess business interest income.

**Form 8990, Limitation on Business Interest Expense Under Section 163(j).** Generally, a taxpayer with business interest expense, a disallowed business interest expense carryforward, or current or prior year excess business interest expense must file Form 8990, unless an exclusion applies.

**Pass-through entity.** A pass-through entity that is not a small business taxpayer and is allocating excess taxable income or excess business interest income to its owners must file Form 8990 regardless of whether it has any interest expense.

**Small business.** A small business taxpayer is not subject to the business interest limitation and is not required to file Form 8990. A small business taxpayer is a taxpayer that is not a tax shelter, and has average annual gross receipts of \$31 million (2025) or less for the three prior tax years.

**Pass-through entity not subject to limitation.** A shareholder subject to the limitation who owns a pass-through entity that is not subject to the limitation must include his or her share of the pass-through business interest expense, adjusted taxable income, and business interest income on Form 8990. Shareholders must request this information from the pass-through entity.

## 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:

Percentage of stock owned × Percentage of year owned

**Example:** Sam and Dan each owned 50% of S&D, an S corporation, for the first half of the year. 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 1120-S 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,
- 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 S Corporation Items

On Form 1120-S, 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 1120-S).

Examples of separately stated items include:

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

**Section 199A information.** The qualified business income deduction (QBI), also known as the section 199A deduction, is determined at the shareholder level. The S corporation should enter code V with an asterisk (V\*) on line 17 of each shareholder's Schedule K-1 and enter "STMT" in the space to indicate that the information is provided on an attached statement that separately identifies the shareholder's pro rata share of:

- Qualified items of income, gain, deduction, and loss,
- Form W-2 wages,
- Unadjusted basis immediately after acquisition (UBIA) of qualified property,
- Qualified publicly traded partnership (PTP) items, and
- Section 199A dividends, also known as qualified real estate investment trust (REIT) dividends.

The S corporation makes an initial determination of which items are qualified items of income, gain, deduction, and loss at its level and reports to each shareholder their pro rata share of all items that may be qualified items at the shareholder level. The shareholder must then determine whether each item is includible in QBI.

Additionally, the S corporation must report whether any of its trades or businesses are specified service trades or businesses (SSTBs) and identify any trades or businesses that are aggregated.

**Required statements.** These statements can be found in the instructions for Form 1120-S.

- *Statement A—QBI Pass-Through Entity Reporting.*
- *Statement B—QBI Pass-Through Entity Aggregation Election(s).*
- *Statement C—QBI Pass-Through Entity Reporting—Patrons of Specified Agricultural and Horticultural Cooperatives.*

For additional information, see *Qualified Business Income Deduction (QBI)—IRC §199A*, page 8-15.

**Disposal of Section 179 property.** If the S corporation disposes of property for which the Section 179 expense deduction was ever taken, special rules apply. See *Dispositions of property with Section 179 deductions*, page 20-10.

**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)]

**Limitation on losses.** Excess business losses of a taxpayer other than a C corporation must be carried forward. An excess business loss is the amount by which the total deductions from the taxpayer's trade or business exceed the taxpayer's gross income or gains from such trade or business, plus a threshold amount [\$313,000 (\$626,000 MFJ) for 2025.]

**OBBBA** The OBBBA made the excess business loss limitation permanent.

**S corporation shareholders.** In the case of an S corporation, the provision applies at the shareholder level. Each shareholder's pro rata share of items of income, gain, deduction, or loss are taken into account in applying the limitation for the taxable year.

This loss limitation applies after the application of the at-risk and passive loss rules. For more information, see *Excess Business Loss Limitation*, page 5-13, 1040.

## Schedules K-2 and K-3 (Form 1120-S)

Schedule K-2 (Form 1120-S), *Shareholders' Pro Rata Share Items—International*, and Schedule K-3 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.—International*, are used to report items of international tax relevance, including foreign source income, assets generating foreign income, ownership in certain types of foreign entities, and foreign taxes paid or accrued.

The Schedule K-2 and K-3 filing requirements for S corporations generally follow the rules for partnerships. For additional information, see *Schedules K-2 and K-3 (Form 1065)*, page 20-11.

**Domestic filing exception.** A domestic S corporation that meets the following three criteria does not need to file Schedules K-2 and K-3 with the IRS or furnish Schedule K-3 to a shareholder (except when requested).

- 1) **No or limited foreign activity.** Foreign activity is restricted to passive category income with \$300 or less of foreign taxes paid or accrued, and the foreign income is reported to the S corporation on a payee statement such as Form 1099-DIV.
- 2) **Shareholder notification.** The S corporation must notify the shareholders at the latest when the S corporation furnishes the Schedule K-1 to the shareholder. The notice can be provided as an attachment to Schedule K-1 and state that the shareholder will not receive Schedule K-3 unless the shareholder requests the schedule.
- 3) **No K-3 requests by the 1-month date.** The S corporation must not receive a request for Schedule K-3 from any shareholder on or before the 1-month date. See *1-month date*, and *Request after the 1-month date*, page 20-12.

**Form 1116 exemption.** An S corporation that does not meet the domestic filing exception, above, may meet the Form 1116 exemption exception. See *Form 1116 exemption exception*, page 20-12.

**Other filing situations.** The instructions for Form 1120-S provide examples of other filing situations for Schedule K-2 and Schedule K-3. For examples of completed schedules, see *Schedules K-2 and K-3 (Form 1120-S)*, in the *S Corporation Example*, page 19-17.

## Shareholder Basis

### Cross References

- Schedule K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.*
- Form 7203, *S Corporation Shareholder Stock and Debt Basis Limitations*
- IRC §1367, *Adjustments to basis of stock of shareholders, etc.*

### Related Topics

- At-Risk Rules, page 7-12
- Partner's Basis in the Partnership (Outside Basis), page 20-13

### 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 as 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*, next column).

- If nondeductible expenses exceed basis, they do not get carried forward unless the shareholder elects to switch the order. If this election is made, the excess expenses retain their character and are carried forward to the succeeding tax year. See *Election to switch order of basis adjustments*, next column.
- 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 19-11.
- 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 debt basis.** Stock basis and debt basis are adjusted and applied separately.

**Note:** Neither basis can be decreased 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* chart, next column.

**Deductibility of flow-through losses and deductions—stock and/or debt basis.** Debt 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 debt basis of \$5,000, which occurred when he made a direct loan to the corporation.

In 2025, 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 debt 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 (Form 1120-S) in the amount of \$3,000. Bert can apply the losses against debt basis.

	<b>Stock Basis</b>	<b>Debt Basis</b>
Beginning basis	\$ 3,500	\$5,000
\$4,000 cash distribution	(3,500)	
Distributions can go against stock basis only. Basis cannot go below zero.	\$ 0 \$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 debt basis remaining, meaning he will be able to deduct up to \$2,000 of future flow-through losses against his debt basis.

See *Basis restorations apply first to debt basis*, page 19-11.

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

**Form 7203, S Corporation Shareholder Stock and Debt Basis Limitations.** Use Form 7203 to compute potential limitations of a taxpayer's share of the S corporation's deductions, credits, and other items that can be deducted on his or her return. Form 7203 must be filed by an S corporation shareholder who:

- Is claiming a deduction for his or her share of an aggregate loss from an S corporation (including an aggregate loss not allowed last year because of basis limitations),
- Received a non-dividend distribution from an S corporation,
- Disposed of stock in an S corporation (whether or not gain is recognized), or
- Received a loan repayment from an S corporation.

**Stock block.** When a shareholder has a different basis in different blocks of stock, pass-through items are generally allocated pro rata to all shares, regardless of their different bases. If there is a partial stock sale or partial redemption, a taxpayer may file more than one Form 7203.

## S Corporation Shareholder's Basis Adjustments

### Order of Adjustments in Stock Basis

<b>Basis is increased by:</b>	<b>Schedule K-1...</b> <sup>1</sup>
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.	Box 16 codes A and B
5) Excess depletion.	Box 15 code C
<b>Basis is decreased by:</b>	<b>Schedule K-1...</b> <sup>1</sup>
6) Distributions. <sup>2</sup>	Box 16 code D
7) Nondeductible expenses. <sup>3,4</sup>	Box 16 code C and box 17 code R
8) Ordinary loss.	Box 1
9) Separately stated loss items.	Boxes 2–12

<sup>1</sup> See *Schedule K-1 Codes (Form 1120-S)—S Corporation*, page 19-2.

<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*, below.

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

**Note:** Stock basis cannot be decreased below zero.

For information about whether to apply basis increases to stock basis or debt basis, see *Basis restorations apply first to debt basis*, page 19-11.

**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*, above). 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, 2024 is \$10,000. There were no distributions in 2025. Redcorp passes through the following items on Lucy's 2025 Schedule K-1 (Form 1120-S).

- 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	
<i>Basis 12/31/24</i>	\$10,000	<i>Basis 12/31/24</i>	\$10,000
<i>Nondeductible items</i>	\$ 2,500	<i>Ordinary loss</i>	\$10,000
<i>Basis subtotal</i>	\$ 7,500	<i>Basis subtotal</i>	\$ 0
<i>Ordinary loss</i>	\$10,000	<i>Nondeductible items</i>	\$ 2,500
<i>Result</i>	Deductible loss of \$7,500, carryover loss of \$2,500, zero basis	<i>Result</i>	Deductible loss of \$10,000, carryover of nondeductible items, zero basis

## Loans

**Direct loans.** An S corporation shareholder's debt 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.

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. [Reg. §1.1366-2(a)(2)(i)]

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:** Married taxpayers took out annual loans from their wholly-owned partnership. They then loaned identical amounts of money to their S corporation, which in turn paid equivalent amounts of rent back to the partnership. The court held that the taxpayers 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 taxpayers had no economic outlay. (*Kerzner*, T.C. Memo. 2009-76)

**Loan guarantees.** A shareholder acting as a guarantor of S corporation indebtedness does not create or increase his or her debt basis simply by becoming a guarantor. Only when a shareholder makes a payment on bona fide indebtedness of the S corporation for which the shareholder has acted as guarantor may his or her basis of indebtedness be increased and only by the amount of such payment. [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.

**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 could 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 7-12.

**Basis restorations apply first to debt basis.** If debt 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 debt basis is restored up to the loan balance (original loan less repayments).

**Example:** Alan owns 100% of Colmes Corp, an S corporation. In 2024, Colmes Corp passed through losses of \$4,500. There were no distributions of cash or property. Alan's stock basis was \$0, and his debt basis was \$10,000. Alan deducted the losses by applying them against his debt basis, bringing his debt basis to \$5,500 (\$10,000 – \$4,500).

In 2025, Colmes Corp passed through net income of \$6,000. Under the basis restoration rules, the income had to be applied first to restoration of debt 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 debt basis. The distribution was taxable because it exceeded the loan's basis. [*Nathel*, 131 T.C. No. 17 (2008)]

**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:** 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.

## 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 19-7.

**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 2025. 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 19-13.

## Discharge of Indebtedness

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

**Reduction of tax attributes.** To the extent that an S corporation is insolvent or qualifies for another income exclusion at the time of debt cancellation, it must file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, to disclose the discharged indebtedness and reduce tax attributes, as applicable.

**Author's Comment:** If a shareholder has suspended losses from the S corporation, the reduction of tax attributes reduces those suspended losses.

## Distributions

### Cross References

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

### Related Topics

- Part II—Partnerships and S Corporations, page 7-2
- Distributions to Shareholders, page 18-15

## S Corporations With No Earnings and Profits (E&P)

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 debt basis*, page 19-10.

## Accumulated Adjustments Account (AAA)

A corporation with earnings and profits must maintain an AAA to determine taxability of distributions to shareholders.

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

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

The taxation of distributions in excess of the AAA depends on whether the corporation has accumulated earnings and profits (E&P). See *Ordering Rules*, below.

**Example:** On January 1, 2024, Shannon formed Chalker, Inc., an S corporation. For tax year 2024, 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 AAA. Shannon did not receive any distributions in 2024.

In 2025, Shannon took a distribution of \$15,000 from Chalker, Inc. Since the AAA had a balance of \$16,000, the distribution was not taxable to Shannon. The distribution caused a negative adjustment to the AAA, which had a balance of \$1,000 after the distribution.

**Corporate account.** The AAA 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 AAA and is eligible to receive tax-free distributions.

**Adjustments.** The AAA 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 AAA can have a negative balance from losses (but not from distributions). The deficit is made up by positive adjustments in future years.

**Global intangible low-taxed income (GILTI).** The IRS has issued a notice containing transition rules for S corporations with accumulated earnings and profits (AE&P) and their shareholders by allowing them to recognize the GILTI inclusion amount at the entity level. Under these rules, the GILTI inclusion amount is treated as an item of income. As a result, the S corporation's AAA increases before allocation to the shareholders. This increase in AAA will allow S corporations to:

- Distribute property to shareholders, and
- Avoid dividend treatment.

Proposed regulations will be issued to replace the notice and will provide that the transition rules and examples in the notice may be applied to tax years of S corporations ending on or after June 22, 2019. (Notice 2020-69)

For more information on GILTI, see *Global intangible low-taxed income (GILTI)*, page 18-12.

## Other Adjustments Account (OAA)

The OAA 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) In 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 2023, the accumulated adjustments account had a balance of \$12,500. Todd's stock basis was also \$12,500. In 2023, Leftfield, Inc. passed through a loss to Todd in the amount of \$15,000.

In 2024, Leftfield, Inc., made a distribution to Todd of \$3,000 and passed through a loss of \$1,200.

In 2025, Leftfield, Inc. passed through income of \$6,000 to Todd.

	AAA	Stock Basis
Beginning basis	\$12,500	\$12,500
Pass through loss \$15,000	(15,000)	(12,500)
Balance 12/31/23	(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 12/31/24	(3,700)	\$ 0 (increases suspended loss to \$3,700)
Pass through income \$6,000	\$ 6,000	\$ 6,000
Balance 12/31/25	\$ 2,300	(3,700) \$ 2,300 (Todd reports the \$6,000 income and also picks up the \$3,700 suspended loss on his tax return)

## Reporting AAA and OAA

AAA and OAA are reported on Form 1120-S (Schedule M-2). For more information, see *Schedule M-2*, page 19-22.

## Election to Distribute Earnings and Profits (E&P) First

An S corporation can elect to alter the ordering rules and distribute E&P first and amounts from the AAA 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 E&P through a deemed dividend. The election is considered to be an election to distribute E&P first. 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 19-12.

**Making the election.** To make the election to distribute E&P first, or the election for deemed dividends, attach a statement to a timely filed original or amended Form 1120-S 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 AAA and the OAA 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 (E&P) First*, previous column.

**Duration.** The post termination transition period generally 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 *Built-In Gains (BIG) Tax*, page 19-14, and *Corporate Liquidations*, page 18-22.

**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, as follows.

### Deducting Shareholder's Suspended Pass-Through Losses

Cause of Suspended Loss	Treatment at Liquidation
Basis limitation. See <i>Shareholder Basis</i> , page 19-9.	Permanently lost. [Reg. §1.1366-2(a)(6)]
At-risk limitation. See <i>At-Risk Rules</i> , page 7-12.	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 7-7.	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)]
Excess business loss limitation. See <i>Excess Business Loss Limitation</i> , page 5-13.	Treated as NOL carried over to next year. [IRC §461(l)(2)]

## S Corporation Taxes

### Cross References

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

### Related Topics

- Passive Activity Loss Limits, page 7-7
- Inventory, page 8-13

## 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 federal 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 21% 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 2001, has earnings and profits at the close of 2024, and taxable income of \$72,200. Income for the year includes the following.

- Gross sales of \$100,000,
- Sale of real estate for \$50,000, with adjusted basis of \$30,000,
- Interest income of \$15,000, Rent receipts of \$50,000, but with related expenses of \$35,000, Sale of publicly-traded stock for \$7,000, with basis of \$10,000, and
- 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 five years have passed since the S corporation election was effective. See *Built-In Gains (BIG) Tax*, below.

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 21% of the lesser of ENPI or taxable income. In this example, the corporation incurs an excess net passive income tax of \$1,085 (21% of \$5,169).

### Built-In Gains (BIG) Tax

If a corporation has always been an S corporation, BIG tax does not apply. [IRC §1374(c)(1)]

BIG tax applies if:

- A C corporation elects S corporation status, and
- The combined FMV of the corporation's property is greater than basis, and
- The property is sold or distributed within five years of the S election.

**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.....	<u>\$14,200</u>	<u>\$7,900</u>	<u>\$6,300</u>

Since the combined FMV of the corporation's property is greater than basis, the corporation is subject to BIG tax if the property is sold or distributed within five years.

BIG 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. BIG 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 BIG tax provisions applicable to the taxable year in which the sale was made. [IRC §1374(d)(7)(B)]

**Tax rate.** BIG tax is recognized if built-in gain property is sold or distributed. Tax is 21% of the net recognized built-in gain (limited to taxable income computed as if the corporation were a C corporation).

**Reporting.** BIG tax is computed and reported on Schedule D (Form 1120-S), *Capital Gains and Losses and Built-In Gains*.

Net unrealized built-in gains reduced by net recognized built-in gains from prior years is listed on Form 1120-S (Schedule B), *Other Information*.

**Pass through.** Built-in gains passing through to shareholders on Schedule K-1 (Form 1120-S), are reduced by the amount of BIG 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, 2024, 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, 2025, Doctor Jekyll converts his C corporation into an S corporation. During the first three months of 2025, Hyde Medical Clinic collects all its accounts receivable and pays accounts payable that were outstanding on December 31, 2024.

Hyde Medical Clinic must pay tax on \$65,000 of built-in-gains (\$85,000 AR minus \$20,000 AP). The tax equals \$13,650 (\$65,000 × 21%). In addition, the \$65,000 of income passes through to Doctor Jekyll on Schedule K-1 (Form 1120-S).

Doctor Jekyll is allowed a \$13,650 deduction against his \$65,000 Schedule K-1 income (netted on the Schedule K-1). Assuming Doctor Jekyll's personal tax rate is 24%, he must pay an additional tax of \$12,324 (\$51,350 × 24%), making total tax on the \$65,000 net profit equal to \$25,974 (\$13,650 + \$12,324) for a combined tax rate of 40%.

**Solution:** If in December 2024, Hyde Medical Clinic had accrued a bonus of \$65,000 payable to Doctor Jekyll, the BIG tax would not have applied.

*continued on next page*

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

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 2024. Doctor Jekyll's bonus can be paid in 2025 and can be funded by collection of the accounts receivable.

See *Reasonable Compensation*, page 19-16.

**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 BIG 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*.

An S corporation that allocated any or all of a qualified investment to its shareholders must provide the information the shareholders need to recompute the 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 calculated 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)]

## Estimated Tax Payments

An S corporation must make estimated tax payments if estimated tax due is \$500 or more. 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 *Electronic Federal Tax Payment System (EFTPS)*, page 23-2.

## State and Local Taxes Paid

Guidance is available for individual owners of S corporations and partnerships in calculating their state and local tax (SALT) deduction limitations (Notice 2020-75). Most states refer to this as the pass-through entity (PTE) tax. The rules apply to S corporations and their shareholders the same as for partnerships and their partners. For more information, see *State and Local Taxes Paid*, page 20-10.

## Cross References

- Form 1128, *Application to Adopt, Change, or Retain a Tax Year*
- IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*

## Related Topics

- Accounting Periods, page 8-26
- Reasonable Compensation, page 18-14

## Required Tax Year for S Corporations and PSCs

All S corporations and personal service corporations (PSCs) must use a calendar tax year unless any of the following apply.

- Corporation makes an election under IRC section 444.
- Corporation elects to use a 52–53 week tax year ending with reference to the calendar year or a tax year elected under IRC section 444.
- The corporation can establish a business purpose tax year.

When electing S corporation treatment on Form 2553, *Election by a Small Business Corporation*, a qualifying business may elect a tax year other than a calendar year.

An existing partnership, S corporation, or PSC must use Form 1128, *Application to Adopt, Change, or Retain a Tax Year*, to elect a tax year other than a calendar year and the entity is not electing a tax year under IRC section 444. See *Election other than required taxable year (IRC §444)*, and *Business purpose tax year*, below.

**Election other than required taxable year (IRC §444).** A partnership, S corporation, or PSC can make an IRC section 444 election if it meets all the following requirements.

- It has not previously had an IRC section 444 election in effect,
- It is not a member of a tiered structure, and
- It elects a year that meets the deferral period requirement.

**Deferral period.** If the entity is retaining its tax year, the entity can make an IRC section 444 election to retain its tax year if the deferral period of the new tax year is three months or less. This deferral period is the number of months between the beginning of the retained year and the close of the first required tax year. If the entity is adopting or changing to a tax year other than its required year, the deferral period is the number of months from the end of the new tax year to the end of the required tax year. The deferral period must be the shorter of three months or the deferral period of the tax year being changed.

**Required payment.** If an IRC section 444 election is made, the entity must make a required payment (or tax deposit) with the IRS which represents the value of the tax deferral that the owners receive through the use of a tax year different from the required tax year. The deposit remains with the IRS (interest free) for as long as the IRC section 444 election is in effect. The amount left on deposit with the IRS is adjusted up or down each year, depending on taxable income. For more details, see Form 8752, *Required Payment or Refund Under Section 7519*.

**Business purpose tax year.** A partnership, S corporation, or PSC can gain automatic approval to use a tax year other than its required tax year if it can establish a natural business year. This is done by satisfying the 25% gross receipts test as follows.

- 1) Gross receipts for the most recent 12-month period that ends with the last month of the requested tax year are totaled and then divided into the gross receipts for the last two months of this 12-month period.
- 2) The same computation as in (1) above is made for the two preceding 12-month periods ending with the last month of the requested tax year.

If the percentage determined for each of the three tax years equals or exceeds 25%, the requested tax year is a natural business year.

Use Form 1128, *Application to Adopt, Change or Retain a Tax Year*, to change the entity's tax year.

**Exception:** The taxpayer must determine whether any annual accounting period other than the requested period also meets the 25% gross receipts test. If one or more other annual accounting periods produce higher averages (rounded to 1/100 of a percent), then the requested tax year will not qualify as the taxpayer's natural business year.

**Special rule.** A business purpose tax year can also be established under the annual business cycle test, the seasonal business test, or the facts and circumstances test. Each of these tests requires the entity to obtain advance approval from the IRS. (Rev. Proc. 2006-46).

## Employee Business Expense for S Corporation Shareholder

There is no provision for S corporation shareholders to deduct unreimbursed expenses as a separate item from income on Schedule E like a partner in a partnership can. See *Unreimbursed Partnership Expenses*, page 20-12.

**Accountable plan.** A S corporation with an accountable plan in place can reimburse shareholder employees for authorized expenses. See *Accountable/Nonaccountable Plans*, page 8-11.

## 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 of 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 (2002)</li> <li>• <i>Veterinary Surgical Consultants, P.C.</i>, 117 T.C. No. 141 (2001)</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:** S corporations may be set up for the primary purpose of avoiding payroll taxes on wages to shareholders. This approach does not comply with tax law. The highest non-compliance issue in S corporations has been identified 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.

**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.** An internet search can yield comparable wage information for specific locations and areas of expertise.

**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.

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**Court Case:** The taxpayer, an individual, received nonemployee compensation from a financial services firm and an insurance company. The taxpayer reported the income received as well as expenses on Form 1120-S. On his individual Form 1040, he reported wages as well as non-passive income from the S corporation. The IRS argued that the gross receipts and expenses should have been reported on Schedule C (Form 1040) and not on Form 1120-S.

The taxpayer argued that the S corporation could not enter into the contracts because it was not registered under the securities laws. The Tax Court held that the fact that the S corporation was prevented from engaging in securities sales did not allow the taxpayer to assign income earned as an individual to the S corporation. Therefore, the taxpayer, not the S corporation should have reported the income on his personal return. (*Fleischer*, T.C. Memo. 2016-238)

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## 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 Benefits*, Tab 22.

**Self-employed health insurance.** A more than 2% shareholder-employee of an S corporation is allowed 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 5-10.

**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, e.g. NOLs and disallowed charitable contributions, cannot carry over from a C corporation to an S corporation. However, the statutes of limitations continue to run. [IRC §1371(b)]

**Example:** Barry Corp, a C corporation, donated \$10,000 to charity in 2023, but only had taxable income of \$50,000. The charitable contributions in excess of the deduction limit may be carried over to each of the subsequent five years (2024, 2025, 2026, 2027, and 2028). On January 1, 2025, Barry Corp elected to be taxed as an S corporation. Although the charitable contribution carryover is not used up, it may not be used by the S corporation, nor passed on to the S corporation shareholders. If Barry Corp remains an S corporation past 2028, the carryover will expire and be lost.

**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 19-14.

**Passive losses exception.** Losses suspended under passive loss limitation rules may carry over from a C corporation to an S corporation. [IRC §469(f)(2)]

**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 1120-S, *U.S. Income Tax Return for an S Corporation*.

Compare this *S Corporation Example* to the *C Corporation Example* in Tab 18 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. Income and deductions are reported on Form 1120-S, then passed through to shareholders on Schedule K-1 (1120-S). 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 19-9.

**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 19-12.

**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 S Corporation Items*, page 19-8.

## 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 19-5.

The tax consultant obtained an employer identification number (EIN) for the business. For information about obtaining an EIN, see page 5-1.

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.

**Business start date.** Greener Pastures, Inc. started doing business on April 1, 2025.

## 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*, page 19-19. Total shareholder wages reported are \$63,955 (\$55,755 + \$3,900 + \$4,300) for Nate, and \$52,445 (\$44,245 + \$3,900 + \$4,300) for Tyler.

*continued on page 19-19*

## Payroll Report for Year Ended December 31, 2025

Employee	Gross Earnings	Social Security 6.20%	Medicare 1.45%	Federal Withholding	State Withholding	Health Insurance & HSA Contributions*	SIMPLE Elective Deferrals	Net Pay
Nate	\$ 63,955.00	\$ 3,456.81	\$ 808.45	\$ 9,204.00	\$ 3,336.00	\$ 8,200.00	\$ 5,500.00	\$ 33,449.74
Tyler	\$ 52,445.00	\$ 2,743.19	\$ 641.55	\$ 6,324.00	\$ 1,924.00	\$ 8,200.00	\$ 4,500.00	\$ 28,112.26
Evan	\$ 31,200.00	\$ 1,934.40	\$ 452.40	\$ 2,493.00	\$ 1,635.00		\$ 3,120.00	\$ 21,565.20
Cyndi	\$ 27,300.00	\$ 1,692.60	\$ 395.85	\$ 2,007.00	\$ 1,369.00		\$ 2,730.00	\$ 19,105.55
Tristan	\$ 23,400.00	\$ 1,450.80	\$ 339.30	\$ 1,521.00	\$ 1,104.00		\$ 2,340.00	\$ 16,644.90
Jordan	\$ 23,400.00	\$ 1,450.80	\$ 339.30	\$ 1,521.00	\$ 1,104.00		\$ 2,340.00	\$ 16,644.90
Totals	\$221,700.00	\$12,728.60	\$2,976.85	\$23,070.00	\$10,472.00	\$16,400.00	\$20,530.00	\$135,522.55

### Final Pay Period—Taxes Deposited January 2026

	Gross Earnings	Social Security 6.20%	Medicare 1.45%	Federal Withholding	State Withholding	Health Insurance HSA Contributions	SIMPLE Elective Deferrals	Net Pay
	\$ 5,264.10	\$ 326.37	\$ 76.33	\$ 592.00	\$ 269.00		\$ 526.00	\$ 3,474.40

\* Health insurance premiums and HSA contributions paid on behalf of greater than 2% shareholders are included in boxes 1 and 16 (if applicable) of the shareholder's Form W-2. The items are also reported individually in box 14, Form W-2.

## 2025 Tax Depreciation Schedule—Greener Pastures, Inc.

Asset	Placed in Service	Basis	Section 179	Depreciable Basis	Recovery Period	Method
Equipment	April 1, 2025	\$49,900.00	\$ 0.00	\$49,900.00	7 yr.	200DB
Display shelving	April 1, 2025	\$10,000.00	\$10,000.00	\$ 0.00	7 yr.	200DB
Office furniture	April 1, 2025	\$ 5,000.00	\$ 0.00	\$ 5,000.00	7 yr.	200DB
Computers	April 1, 2025	\$ 4,500.00	\$ 0.00	\$ 4,500.00	5 yr.	200DB
Totals		\$69,400.00	\$10,000.00	\$59,400.00		

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

Equipment.....	\$49,900 × 1/2 × 200% × 4.5/12 =	\$5,346
Office furniture.....	\$5,000 × 1/2 × 200% × 4.5/12 =	\$ 536
Computers.....	\$4,500 × 1/5 × 200% × 4.5/12 =	\$ 675
Total regular tax depreciation.....		\$6,557

**Alternative minimum tax (AMT) adjustment.** For property placed in service after 2015 which qualifies for any special depreciation allowance, no AMT adjustment needs to be made for that class of property, even if the taxpayer elects out of such allowance. (Rev. Proc. 2017-33)

## Balance Sheet—Greener Pastures, Inc.

December 31, 2025

<b>Assets:</b>	
Cash.....	\$ 89,832.53
Inventory.....	14,500.00
Equipment.....	49,900.00
Display shelving.....	10,000.00
Office furniture.....	5,000.00
Computers.....	4,500.00
Accumulated depreciation.....	(16,557.00)
Total assets.....	\$157,175.53
<b>Liabilities:</b>	
Payroll withholding payable.....	\$ 1,263.70
Employer's Social Security and Medicare payable.....	402.70
Sales tax payable.....	2,028.14
SIMPLE employee deferrals payable.....	526.00
Loan payable.....	43,943.66
Rounding adjustment.....	.01
Total liabilities.....	\$ 48,164.21
<b>Equity:</b>	
Common stock.....	\$100,000.00
Current earnings.....	19,011.32
Distributions.....	(10,000.00)
Total equity.....	\$109,011.32
Total liabilities plus equity.....	\$157,175.53

## Income Statement—Greener Pastures, Inc.

Year ended December 31, 2025

### Revenue:

Lawn and garden implement sales.....	\$265,500.00
Hydroseeding services.....	288,300.00
Dividends earned.....	665.00
Gross income.....	\$544,465.00

### Cost of goods sold:

Beginning inventory.....	\$ 0.00
Purchases.....	218,730.77
Ending inventory.....	(14,500.00)
Cost of goods sold.....	\$204,230.77
Gross profit.....	\$350,234.23

### Expenses:

Accounting (organization costs).....	\$ 2,500.00
Advertising.....	3,000.00
Attorney fees (organization costs).....	2,000.00
Bookkeeping.....	2,800.00
Depreciation.....	16,557.00
Employee benefit programs	
HSA contributions.....	17,200.00
Health insurance.....	15,600.00
SIMPLE employer match.....	6,651.00
Foreign tax paid.....	99.00
Insurance—business.....	3,250.00
Interest expense.....	1,577.02
Meals and entertainment.....	1,100.00
Office expenses.....	2,325.00
Payroll taxes.....	19,553.89
Rent.....	10,800.00
Travel (start-up costs).....	1,660.00
Utilities.....	2,850.00
Wages (includes \$8,600 for shareholder HSA contributions and \$7,800 for health insurance).....	221,700.00

Total expenses.....	\$331,222.91
Net income per books.....	\$ 19,011.32

# Cash Flow Reconciliation

Business Name: Greener Pastures, Inc.		Period: 4/1/25 to 12/31/25	EIN: 31-2345678
1) Starting cash balance .....		1) 0.00	
<b>Cash In</b>			
2) Customer receipts: categories			
Lawn and garden implement sales	265,500.00		
Hydroseeding services	288,300.00		
Sales tax collected	18,253.13		
Total customer receipts.....		2) 572,053.13	
3) Investment income: interest, dividends, etc.			
Dividend income	665.00		
Total investment income.....		3) 665.00	
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) 49,900.00	
8) Contributions to capital .....		8) 100,000.00	
9) Other receipts.....		9) _____	
Total starting cash balance plus cash in.....		722,618.13	
<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 \$8,600 for shareholders)	25,800.00		
Health insurance (includes \$7,800 for shareholders)	23,400.00		
SIMPLE plan employer match	6,651.00		
SIMPLE plan employee elective deferrals	20,004.00		
Foreign tax paid	99.00		
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)	53,083.49		
State unemployment	3,596.44		
State withholding	10,203.00		
Rent	10,800.00		
Sales tax	16,224.99		
Travel (start-up costs)	1,660.00		
Utilities	2,850.00		
Wages/net	135,522.55		
Total business expenses .....		10) 327,121.47	
11) Purchases of inventory.....		11) 218,730.77	
12) Loans payable			
Asset    Equipment			
Principal 5,956.34    Interest 1,577.02    = Total.....	7,533.36		
Total loans payable.....		12) 7,533.36	
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) 69,400.00	
17) Other cash out: categories.....		17) _____	
Total cash out for period.....		632,785.60	
Ending cash balance.....		89,832.53	

continued from page 19-17

**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 an adjustment 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. For more information about reporting these amounts, see the instructions for Form 1120-S, lines 7 and 8, page 19-20.

For information about health insurance policies taken out under an S corporation, see *Self-employed health insurance*, page 19-16.

**Employee benefits.** The corporation will pay health insurance premiums of \$3,900 for each employee. It will also contribute to both HSA and SIMPLE plans for each employee.

**Health savings accounts.** The corporation will contribute \$4,300 to an HSA for each individual. For information on how to report on Form 1120-S, see *Line 18. Employee benefit programs*, page 19-21. For more information about HSAs, see *Health Savings Accounts (HSAs) (IRC §223)*, page 22-6.

**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)*, page 13-14.

**Employee-shareholder expenses.** Shareholders are personally responsible for paying for their own professional publications, association dues, and uniforms. As corporation shareholders, these amounts are treated as employee business expenses. These expenses are not deductible for the shareholder. See *Employee Business Expense for S Corporation Shareholder*, page 19-16. Compare to the same expenses in the *Partnership Example* in Tab 20, which are fully deductible and also reduce self-employment taxes.

**Tax year.** The S corporation adopts a calendar tax year. The first tax year is a short

tax year beginning on April 1, 2025, and ending on December 31, 2025. The corporation will establish its calendar tax year with the IRS when it files its first income tax return. See *Short Tax Year Depreciation*, page 9-6, and *Required Tax Year for S Corporations and PSCs*, page 19-15.

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

**Inventory.** The S corporation will hold inventory consisting of lawn and garden implements and hydroseeding materials. For more information about accounting for inventory, see *Inventory/Cost of Goods Sold (COGS)*, page 8-13.

## 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, 2025. 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 2025. See *Start-Up Costs and Organizational Costs*, page 18-11.

## Purchase of Assets

Greener Pastures Inc. took out a bank loan of \$49,900 to purchase equipment for hydroseeding. It paid cash for display shelving, office furniture, and computers, totaling \$19,500.

Equipment.....	\$49,900
Display shelving.....	10,000
Office furniture.....	5,000
Computers.....	4,500
Total.....	\$69,400

The corporation elects out of the special depreciation allowance.

**Section 179 deduction and depreciation.** A Section 179 deduction of up to \$2,500,000 is available for tax year 2025. Greener Pastures, Inc. elects to claim a Section 179 deduction for the display shelving 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 1120-S. For an S corporation, any amount claimed as a Section 179 deduction is passed through to shareholders on Schedule K-1 (Form 1120-S). The shareholders in this example will deduct the Section 179 expense from Schedule K-1 on pg. 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 9-6.

See *2025 Tax Depreciation Schedule—Greener Pastures, Inc.*, page 19-18.

## Payroll

**Employees.** Greener Pastures, Inc. hired Evan to assist Tyler with hydroseeding, Cyndi as an assistant store manager, and Tristan and Jordan as salespeople. In addition to wages, the corporation will provide health benefits through health insurance and HSAs, and retirement benefits through a SIMPLE plan. See *Payroll Report for Year Ended December 31, 2025*, page 19-18.

## Distributions

In December 2025, 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 19-5.

## Financial Statements

The balance sheet and income statement for the short year ended December 31, 2025, along with the depreciation schedule and payroll report for Greener Pastures, Inc. can be found on page 19-18. A cash flow reconciliation statement for the short year is found on page 19-19.

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

### Heading information:

**Item B.** Principal business activity codes, see page 25-6.

**Item D.** For information about how to apply for an EIN, see page 5-1.

**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 pg. 1, item F.

## 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 \$265,500 and hydroseeding sales of \$288,300 add up to \$553,800 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 \$204,231.

## 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 \$106,400. Although gross earnings on the payroll report show a combined total of \$116,400 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*.

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**Author's Comment:** Using the above method may result in a discrepancy between the amount listed on lines 7 and 8 with what is reported for payroll tax purposes on Forms 940, 941, W-2, and W-3. To the best of our knowledge, this does not create any matching issues with the IRS.

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

In this example, the deductible salaries and wages amount is \$94,770. The payroll report shows gross earnings of the employees of \$105,300, which are reduced by combined elective deferrals to a SIMPLE plan in the amount of \$10,530.

The \$10,530 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 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

Draft

Form **1120-S** **U.S. Income Tax Return for an S Corporation** OMB No. 1545-0123

Department of the Treasury Internal Revenue Service **2025**

Go to [www.irs.gov/Form1120S](http://www.irs.gov/Form1120S) for instructions and the latest information.

For calendar year 2025 or tax year beginning **4/1**, 2025, ending **12/31**, 2025

**A** S election effective date **4/1/25** Name **Greener Pastures, Inc.** **D** Employer identification number **31-2345678**

**B** Business activity code number (see instructions) **444200** Number and street, if a P.O. box, see instructions. **123 Prairie Point** Room or suite no. **E** Date incorporated **4/1/25**

City or town **Farmdale** State or province **MN** Country **United States** ZIP or foreign postal code **55555** **F** Total assets (see instructions) **\$ 157,176**

**C** Check if Sch. M-3 attached  **G** Is the corporation electing to be an S corporation beginning with this tax year? See instructions.  Yes  No

**H** Check if: (1)  Final return (2)  Name change (3)  Address change (4)  Amended return (5)  S election termination

**I** Enter the number of shareholders who were shareholders during any part of the tax year **2**

**J** Check if corporation: (1)  Aggregated activities for section 465 at-risk purposes (2)  Grouped activities for section 469 passive activity purposes

**Caution:** Include **only** trade or business income and expenses on lines 1a through 22. See the instructions for more information.

Income		Deductions (see instructions for limitations)		Tax and Payments	
1a	Gross receipts or sales	553,800	1c	Balance	553,800
2	Cost of goods sold (attach Form 1125-A)		2		204,231
3	Gross profit. Subtract line 2 from line 1c		3		349,569
4	Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)		4		
5	Other income (loss) (see instructions—attach statement)		5		
6	<b>Total income (loss).</b> Add lines 3 through 5		6		349,569
7	Compensation of officers (see instructions—attach Form 1125-E)		7		106,400
8	Salaries and wages (less employment credits)		8		94,770
9	Repairs and maintenance		9		
10	Bad debts		10		
11	Rents		11		10,800
12	Taxes and licenses		12		19,554
13	Interest (see instructions)		13		1,577
14	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)		14		6,557
15	Depletion (do not deduct oil and gas depletion)		15		
16	Advertising		16		3,000
17	Pension, profit-sharing, etc., plans		17		27,181
18	Employee benefit programs		18		32,800
19	Energy efficient commercial buildings deduction (attach Form 7205)		19		
20	Other deductions (attach statement)		20		17,735
21	<b>Total deductions.</b> Add lines 7 through 20		21		320,374
22	<b>Ordinary business income (loss).</b> Subtract line 21 from line 6		22		29,195
23a	Excess net passive income or LIFO recapture tax (see instructions)	23a			
b	Tax from Schedule D (Form 1120-S)	23b			
c	Add lines 23a and 23b (see instructions for additional taxes)		23c		
24a	Current year's estimated tax payments and preceding year's overpayment credited to the current year	24a			
b	Tax deposited with Form 7004	24b			
c	Credit for federal tax paid on fuels (attach Form 4136)	24c			
d	Elective payment election amount from Form 3800	24d			
z	Add lines 24a through 24d		24z		
25	Estimated tax penalty (see instructions). Check if Form 2220 is attached <input type="checkbox"/>		25		
26	<b>Amount owed.</b> If line 24z is smaller than the total of lines 23c and 25, enter amount owed		26		
27	<b>Overpayment.</b> If line 24z is larger than the total of lines 23c and 25, enter amount overpaid		27		
28	Enter amount from line 27: <b>a</b> Credited to 2026 estimated tax <b>b</b> Refunded		28b		
c	Routing number				
d	Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings				
e	Account number				

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

Signature of officer **Nate** Date \_\_\_\_\_ Title **CEO** May the IRS discuss this return with the preparer shown below? See instructions.  Yes  No

Preparer's name \_\_\_\_\_ Preparer's signature \_\_\_\_\_ Date \_\_\_\_\_ Check  if self-employed PTIN \_\_\_\_\_

Firm's name \_\_\_\_\_ Firm's EIN \_\_\_\_\_ Firm's address \_\_\_\_\_ Phone no. \_\_\_\_\_

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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 \$19,554 (rounded) consists of employer Social Security tax of \$12,728.60, employer Medicare tax of \$2,976.85, FUTA of \$252.00, and state unemployment taxes of \$3,596.44.

**Line 13. Interest.** Include interest expense incurred in the trade or business activities that is not claimed elsewhere on the return. See *Business interest expense limitation*, page 19-8. In this example, \$1,577 (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 \$6,557. The Section 179 deduction of \$10,000 is passed through to shareholders on Schedule K-1 in proportion to their percentages of stock ownership. See *2025 Tax Depreciation Schedule—Greener Pastures, Inc.*, page 19-18.

**Line 16. Advertising.** Include advertising expense not claimed elsewhere on the return. In this example, the corporation paid \$3,000 for advertising.

**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, \$27,181 consists of \$20,530 employee SIMPLE deferrals plus \$6,651 employer 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 Benefits*, Tab 22.

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 \$32,800 deducted on line 18 consists of \$17,200 HSA contributions plus \$15,600 health insurance premiums paid on behalf of non-shareholder employees.

**Line 20. Other deductions.** Attach a schedule listing by type and amount of each deduction included on this line.

**Meals and entertainment.** Meals and entertainment expense of \$1,100 represents \$700 of meals and \$400 of entertainment. The meals were meetings with the shareholders and potential clients. The corporation can deduct 50% of business meals paid or incurred during 2025. The entertainment expense is not deductible.

Following is a statement of other deductions for this example.

**Statement of Other Deductions—  
Line 20, Form 1120-S**

Accounting (organization costs)	\$2,500
Attorney fees (organization costs)	2,000
Bookkeeping	2,800
Insurance-business	3,250
Meals (\$700 × 50%)	350
Office expenses	2,325
Travel and lodging (start-up costs)	1,660
Utilities	2,850
<b>Total other deductions</b>	<b>\$17,735</b>

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

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, \$29,195.
- Line 5a, Ordinary dividends, \$665.
- Line 5b, Qualified dividends, \$665.
- Line 11, Section 179 deduction, \$10,000.

*continued on next page*

- Line 14, International. The S corporation checks the box on Line 14a to indicate that it is filing Schedule K-2 (Form 1120-S), *Shareholders' Pro Rata Share Items—International*.
- Line 16c, Nondeductible expenses. Nondeductible expenses consist of nondeductible entertainment of \$750.
- Line 16d, Distributions, \$10,000. See *Distributions*, page 19-20.
- Line 16f, Foreign taxes paid or accrued, \$99.
- Line 17a, Investment income, \$665.

**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 1120-S filed with the IRS. Also provide the appropriate copy of Schedule K-1 to each shareholder.

See completed *Schedule K-1*, page 19-25, and *Schedule K-1 Codes (Form 1120-S)—S Corporation*, page 19-2.

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, \$16,057.
- Line 5a, Ordinary dividends, \$366
- Line 5b, Qualified dividends, \$366
- Line 11, Section 179 deduction, \$5,500.
- Line 16, code C, Nondeductible expenses, \$413.
- Line 16, code D, Distributions, \$5,500. See *Distributions*, page 19-20.
- Line 16, code F, Foreign taxes paid or accrued, \$54.
- Line 17, code A, Investment income, \$366.
- Line 17, code V. The IRC section 199A (QBI) deduction is determined at the shareholder level. Use code V with an asterisk (V\*) and enter "STMT" to indicate that the information is provided on an attached statement separately identifying the shareholder's pro rata share of IRC section 199A items.

## Schedule L—Balance Sheet per Books

The balance sheet on Form 1120-S 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 11 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 1120-S, 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, trial 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.

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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. See *Net Income (Loss) Reconciliation—Schedule M-3*, page 27-17.

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 Form 1120 (Schedule L).

## 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 11 on Schedule B (total receipts and total assets less than \$250,000).

For more information, see *Schedule M-1, Reconciliation of Income (Loss) per Books With Income per Return*, page 27-16.

**Line 3. Expenses recorded on books this year not included on Schedule K, lines 1 through 12e and 16f.** In this example, items reported on this line are nondeductible meals and entertainment expenses of \$750.

## 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 Adjustments Account (AAA)*, page 19-12.

**Line 2. Ordinary income from page 1, line 22.** In this example, ordinary income from page 1, line 21 is \$29,195.

**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 consist of \$665 dividend 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 consist of Section 179 deduction of \$10,000, foreign withholding of \$99, and nondeductible meals and entertainment expense of \$750, for a total of \$10,849.

**Line 7. Distributions.** Decrease AAA (but not below zero) by cash and 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 (E&P) First*, page 19-13. In this example, the S corporation distributed \$10,000 to shareholders. See *Distributions*, page 19-20.

**Columns (b), Shareholder's undistributed taxable income previously taxed, (c) Accumulated earnings and profits, and (d), Other adjustments account.** These columns are not used in this example. See *Distributions*, page 19-12.

## Schedules K-2 and K-3 (Form 1120-S)

Greener Pastures, Inc. files Schedule K-2 (Form 1120-S), *Shareholders' Pro Rata Share Items—International*, and Schedule K-3 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.—International*, to report its items of international tax relevance. The S corporation earned foreign dividend income of \$665 and had foreign tax withholding of \$99 in Morocco.

The S corporation qualifies for the exception to filing Schedules K-2 and K-3, however, both shareholders notified the S corporation requesting Schedule K-3. As a result, the S corporation must file Schedules K-2 and K-3 with the IRS and furnish Schedule K-3 to the shareholders by the date the S corporation files its tax return. See *Domestic filing exception*, page 19-9.

**Preparing Schedules K-2 and K-3.** Only the relevant portions of Schedules K-2 and K-3 need to be completed. The S corporation completes the following parts of Schedule K-2.

**Part I. Corporation's Other Current Year International Information.** The S corporation checks Box 4 in Part I to indicate reporting of foreign taxes in Part III.

**Part II. Foreign Tax Credit Limitation.** Part II uses the amounts from Form 1120-S to differentiate between U.S. and foreign source income and deductions. Amounts from U.S. sources are reported in column (a) and reflect country code US. Amounts from foreign sources are reported on a separate line using the two-letter country code for the foreign country or U.S. possession from which the income or deduction is sourced. Foreign items are also separated and reported by type of income. A separate line must be used for each country.

Greener Pastures, Inc. completes Section 1, *Gross Income*, and Section 2, *Deductions*, using amounts from Form 1120-S. All U.S. source items of income and deductions are reported in column (a). The foreign dividend income is reported as passive category income in column (c), using country code MO for Morocco.

**Column (f). Sourced by shareholder.** Certain income and deduction items are not assigned on Schedule K-2 to a source or separate category. Examples of these items include foreign currency gains and most types of interest expense. Greener Pastures, Inc. reports its business interest expense of \$1,577 in column (f).

**Schedule K-2.** Schedule K-2 is a summary schedule of all shareholders' shares of the corporation's income, deductions, and credits.

- Part II, Line 1A, Gross sales, \$265,500.
- Part II, Line 2A, Gross income from services, \$288,300.
- Part II, Line 8A, Qualified dividends, \$665.
- Part II, Line 25, Expenses allocable to sales income, \$360,351. {COGS + [(total deductions – interest – depreciation) × 50%]}.
- Part II, Line 26, Expenses allocable to service income, \$156,120. [(Total deductions – interest – depreciation) × 50%].

- Part II, Line 37, Depreciation, \$16,557.
- Part II, Line 41, Business interest expense, \$1,577.
- Part III, Line 1, Foreign taxes, \$99.

**Part III. Other Information for Preparation of Form 1116.** In Part III, Section 3, *Foreign Taxes*, the S corporation assigns foreign taxes paid or accrued to a separate category or source. On line 1A in Section 3, the S corporation uses country code MO and reflects code WHTD in column (a). The code WHTD indicates withholding tax on dividends. In column (d), the foreign tax paid of \$99 is reported as tax paid on passive category income. For the list of codes for types of tax, see the instructions for Schedule K-2 and K-3.

**Schedule K-3.** The S corporation prepares Schedule K-3 to report Nate's 55% pro rata share of the information reported on Schedule K-2.

- Part II, Line 1A, Gross sales, \$146,025.
- Part II, Line 2A, Gross income from services, \$158,565.
- Part II, Line 8A, Qualified dividends, \$366.
- Part II, Line 25, Expenses allocable to sales income, \$198,193.
- Part II, Line 26, Expenses allocable to service income, \$85,866.
- Part II, Line 37, Depreciation, \$9,106.
- Part II, Line 41, Business interest expense, \$867.
- Part III, Line 1, Foreign taxes, \$54.

See Schedules K-2 and K-3 (Form 1120-S), page 19-9.

### Form 7203, S Corporation Shareholder Stock and Debt Basis Limitations

Nate must file Form 7203 because he received a non-dividend distribution from Greener Pastures, Inc. See *Form 7203, S Corporation Shareholder Stock and Debt Basis Limitations*, page 19-10.

*Draft*  
Form 1120-S (2025)  
Page 3

Schedule K Shareholders' Pro Rata Share Items		Total amount
		1
1	Ordinary business income (loss) (page 1, line 29)	29,195
2	Net rental real estate income (loss) (attach Form 8825)	
3a	Other gross rental income (loss)	
3b	Expenses from other rental activities (attach statement)	
3c	Other net rental income (loss). Subtract line 3b from line 3a	
4	Interest income	
5	Dividends: a Ordinary dividends	
5a	b Qualified dividends	665
6	Royalties	
7	Net short-term capital gain (loss) (attach Schedule D (Form 1120-S))	
8a	Net long-term capital gain (loss) (attach Schedule D (Form 1120-S))	
8b	Collectibles (28%) gain (loss)	
8c	Unrecaptured section 1250 gain (attach statement)	
9	Net section 1231 gain (loss) (attach Form 4797)	
10	Other income (loss) (see instructions). Type:	
10	Section 179 deduction (attach Form 4562)	10,000
11		

  

Schedule K-2 (Form 1120-S), Shareholders' Pro Rata Share Items - International, and check this box if you qualified for an exception to filing Schedule K-2 (Form 1120-S)		Total amount
		17a
14a	Attach Schedule K-2 (Form 1120-S), Shareholders' Pro Rata Share Items - International, and check this box if you qualified for an exception to filing Schedule K-2 (Form 1120-S)	
b	Check this box if you qualified for an exception to filing Schedule K-2 (Form 1120-S)	<input checked="" type="checkbox"/>

  

Items Affecting Shareholder Basis		Total amount
		16f
16a	Tax-exempt interest income	
16b	Other tax-exempt income	
16c	Nondeductible expenses	750
16d	Distributions (attach statement if required) (see instructions)	10,000
16e	Repayment of loans from shareholders	
16f	Foreign taxes paid or accrued	99

Form 1120-S (2025)

Page 4  
Form 1120-S (2025)

Schedule K Shareholders' Pro Rata Share Items (continued)		Total amount
		17a
17a	Investment income	665
18	Income (loss) reconciliation. Combine the total amounts on lines 1 through 10. From the result, subtract the sum of the amounts on lines 11 through 12e and 16f	19,761

  

Schedule L Balance Sheets per Books		End of tax year
		18
Assets		(d)
1	Cash	89,833
2a	Trade notes and accounts receivable	
b	Less allowance for bad debts	
3	Inventories	14,500
10a	Buildings and other depreciable assets	
b	Less accumulated depreciation	69,400
15	Total assets	157,176
Liabilities and Shareholders' Equity		
16	Accounts payable	
17	Mortgages, notes, bonds payable in less than 1 year	
18	Other current liabilities (attach statement)	4,221
19	Loans from shareholders	
20	Mortgages, notes, bonds payable in 1 year or more	43,944
21	Other liabilities (attach statement)	
22	Capital stock	100,000
23	Additional paid-in capital	
24	Retained earnings	9,011
25	Adjustments to shareholders' equity (attach statement)	
26	Less cost of treasury stock	
27	Total liabilities and shareholders' equity	157,176

Form 1120-S (2025)

Draft

Form 1120-S (2025) Page 5

**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	19,011	5	Income recorded on books this year	
b	Travel and entertainment \$		7	Add lines 5 and 6	
	Meals & entertainment	750	8	Income (loss) (Schedule K, line 18).	
4	Add lines 1 through 3	19,761		Subtract line 7 from line 4	19,761

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

	(a) Accumulated adjustments account	(b) Shareholders' undistributed taxable income previously taxed	(c) Accumulated earnings and profits	(d) Other adjustments account
1	Balance at beginning of tax year	0		
2	Ordinary income from page 1, line 22	29,195		
3	Other additions	665		
4	Loss from page 1, line 22	( )		
5	Other reductions	(10,849)		
6	Combine lines 1 through 5	19,011		
7	Distributions	10,000		
8	Balance at end of tax year. Subtract line 7 from line 6	9,011		

Form 1120-S (2025)

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SCHEDULE K-2 (Form 1120-S) Shareholders' Pro Rata Share Items—International OMB No. 1545-0123

Department of the Treasury Internal Revenue Service Attach to Form 1120-S. Go to www.irs.gov/Form1120S for instructions and the latest information. 2025

Name of corporation: Greener Pastures, Inc. Employer identification number (EIN): 31-2345678

A Check to indicate the parts of Schedule K-2 that apply.

	Yes	No
1 Does Part I apply? If "Yes," complete and attach Part I.	X	
2 Does Part II apply? If "Yes," complete and attach Part II.	X	
3 Does Part III apply? If "Yes," complete and attach Part III.	X	
4 Does Part IV apply? If "Yes," complete and attach Part IV.		X
5 Does Part V apply? If "Yes," complete and attach Part V.		X
6 Does Part VI apply? If "Yes," complete and attach Part VI.		X
7 Does Part VII apply? If "Yes," complete and attach Part VII.		X

B Check if applicable.  Amended K-2

**Part I Corporation's Other Current Year International Information**  
 Check box(es) for additional specified attachments. See instructions.

<input type="checkbox"/> 1. Gain on personal property sale	<input type="checkbox"/> 5. High-taxed income	<input type="checkbox"/> 8. Form 5471 information	<input type="checkbox"/> 11. Entity treatment for certain S corporations
<input type="checkbox"/> 2. Foreign oil and gas taxes	<input type="checkbox"/> 6. Section 267A disallowed deduction	<input type="checkbox"/> 9. Other forms	<input type="checkbox"/> 12. Reserved for future use
<input type="checkbox"/> 3. Splitter arrangements	<input type="checkbox"/> 7. Form 8858 information	<input type="checkbox"/> 10. Shareholder loan transactions	<input type="checkbox"/> 13. Other international items (attach description and statement)
<input checked="" type="checkbox"/> 4. Foreign tax translation			

**Part II Foreign Tax Credit Limitation**  
 Section 1—Gross Income

Description	(a) U.S. source	Foreign Source				(f) Sourced by shareholder	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code)		
1 Sales							
A US	265,500					265,500	
B							
C							
2 Gross income from performance of services							
A US	288,300					288,300	

Schedule K-2 (Form 1120-S) 2025 Page 2

Name of corporation: Greener Pastures, Inc. EIN: 31-2345678

**Part II Foreign Tax Credit Limitation (continued)**  
 Section 1—Gross Income (continued)

Description	(a) U.S. source	Foreign Source				(f) Sourced by shareholder	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code)		
5 Reserved for future use							
6 Interest income							
A							
B							
C							
7 Ordinary dividends (exclude amount on line 8)							
A							
B							
C							
8 Qualified dividends							
A MO			665			665	

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Schedule K-2 (Form 1120-S) 2025 Page 3

Name of corporation: Greener Pastures, Inc. EIN: 31-2345678

**Part II Foreign Tax Credit Limitation (continued)**  
 Section 1—Gross Income (continued)

Description	(a) U.S. source	Foreign Source				(f) Sourced by shareholder	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code)		
24 Total gross income (combine lines 1 through 23)	553,800		665			554,465	
A US	553,800					553,800	
B MO			665			665	
C							

Schedule K-2 (Form 1120-S) 2025

Schedule K-2 (Form 1120-S) 2025 Page 4

Name of corporation: Greener Pastures, Inc. EIN: 31-2345678

**Part II Foreign Tax Credit Limitation (continued)**  
 Section 2—Deductions

Description	(a) U.S. source	Foreign Source				(f) Sourced by shareholder	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code)		
25 Expenses allocable to sales income	360,351					360,351	
26 Expenses allocable to gross income from performance of services	156,120					156,120	
37 Depreciation not included on line 33 or line 35	16,557					16,557	
41 Other interest expense—business						1,577	
						1,577	

Schedule K-2 (Form 1120-S) 2025 Page 5

Name of corporation: Greener Pastures, Inc. EIN: 31-2345678

**Part II Foreign Tax Credit Limitation (continued)**  
 Section 2—Deductions (continued)

Description	(a) U.S. source	Foreign Source				(f) Sourced by shareholder	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code)		
54 Total deductions (combine lines 25 through 53)	533,028					1,577	
55 Net income (loss) (subtract line 54 from line 24)	20,772		665			(1,577)	
						534,605	

Schedule K-2 (Form 1120-S) 2025 Page 7

Name of corporation: Greener Pastures, Inc. EIN: 31-2345678

**Part III Other Information for Preparation of Form 1116 (continued)**  
 Section 3—Foreign Taxes

Description	(a) Type of tax	(b) Section 951A category income		(c) Foreign branch category income		
		U.S.	Foreign	U.S.	Foreign	Shareholder
1 Direct (section 901 or 903) foreign taxes: <input checked="" type="checkbox"/> Paid <input type="checkbox"/> Accrued	WHTD					
A MO						

Schedule K-2 (Form 1120-S) 2025 Page 8

Name of corporation: Greener Pastures, Inc. EIN: 31-2345678

**Part III Other Information for Preparation of Form 1116 (continued)**  
 Section 3—Foreign Taxes (continued)

Description	(a) U.S. source	(d) Passive category income		(e) General category income		(f) Other (category code)	(g) Total
		U.S.	Foreign	U.S.	Foreign		
1							
A			99				99

671124

Final K-1     Amended K-1    OMB No. 1545-0123

**Schedule K-1 (Form 1120-S) 2025**

Department of the Treasury Internal Revenue Service

For calendar year 2025, or tax year beginning 4 / 1 / 2025 ending 12 / 31 / 2025

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

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

1	Ordinary business income (loss)	13	Credits
	<b>16,057</b>		
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		
5a	Ordinary dividends		
	<b>366</b>		
5b	Qualified dividends	14	Schedule K-3 is attached if checked <input checked="" type="checkbox"/>
	<b>366</b>		
6	Royalties	15	Alternative minimum tax (AMT) items
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)	16	Items affecting shareholder basis
		<b>C</b>	<b>413</b>
10	Other income (loss)	<b>D</b>	<b>5,500</b>
		<b>F</b>	<b>54</b>
11	Section 179 deduction		
	<b>5,500</b>	<b>V*</b>	<b>STMT</b>
12	Other deductions		
17	Other information		
		<b>A</b>	<b>366</b>

**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**

D Corporation's total number of shares  
Beginning of tax year **0**  
End of tax year **100,000**

**Part II Information About the Shareholder**

E Shareholder's identifying number **xxx-xx-xxx1**

F1 Shareholder's name, address, city, state, and ZIP code  
**Nate**

F2 If the shareholder is a disregarded entity, a trust, an estate, or a nominee or similar person, enter the individual or entity responsible for reporting:  
TIN \_\_\_\_\_ Name \_\_\_\_\_

F3 What type of entity is this shareholder? **Individual**

G Current year allocation percentage **55 %**

H Shareholder's number of shares  
Beginning of tax year **0**  
End of tax year **55,000**

I Loans from shareholder  
Beginning of tax year \$ **0**  
End of tax year \$ **0**

**Section 199A Information (Code V)**

Income Items		Non-SSTB	SSTB
Ordinary items	16,057		0
Deduction Items			
Section 179 deduction	5,500		0
Additional Information			
Section 199A W-2 wages	105,914 <sup>1</sup>		0
Section 199A unadjusted basis	38,170 <sup>2</sup>		0

**Shareholder basis computation**

Capital contributions..... \$55,000  
Ordinary income..... 16,057  
Dividend income..... 366  
Section 179 expense..... (5,500)  
Nondeductible expenses..... (413)  
Foreign tax paid..... (54)  
Distribution..... (5,500)  
**Shareholder basis 12/31/2025... \$59,956**

1 W-2 wages = [221,700 - 20,530 (SIMPLE contribution) - 8,600 (shareholder's HSA)] × 55%  
2 Unadjusted basis = 69,400 × 55%

18  More than one activity for at-risk purposes\*  
19  More than one activity for passive activity purposes\*

\* See attached statement for additional information.

For Paperwork Reduction Act Notice, see the Instructions for Form 1120-S. www.irs.gov/Form1120S Cat. No. 11520D Schedule K-1 (Form 1120-S) 2025 Created 4/9/25

OMB No. 1545-0123

2025

**Schedule K-3 (Form 1120-S) Shareholder's Share of Income, Deductions, Credits, etc.—International**

Department of the Treasury Internal Revenue Service For calendar year 2025, or tax year beginning 4 / 1 / 2025, ending 12 / 31 / 25

See separate instructions.

**Information About the Corporation**

A Corporation's employer identification number (EIN) **31-2345678**

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

**Information About the Shareholder**

C Shareholder's identifying number **xxx-xx-xxx1**

D Shareholder's name, address, city, state, and ZIP code  
**Nate**

E Check to indicate the parts of Schedule K-3 that apply.

	Yes	No
1 Does Part I apply? If "Yes," complete and attach Part I	<input checked="" type="checkbox"/>	
2 Does Part II apply? If "Yes," complete and attach Part II	<input checked="" type="checkbox"/>	
3 Does Part III apply? If "Yes," complete and attach Part III	<input checked="" type="checkbox"/>	
4 Does Part IV apply? If "Yes," complete and attach Part IV		<input checked="" type="checkbox"/>
5 Does Part V apply? If "Yes," complete and attach Part V		<input checked="" type="checkbox"/>
6 Does Part VI apply? If "Yes," complete and attach Part VI		<input checked="" type="checkbox"/>
7 Does Part VII apply? If "Yes," complete and attach Part VII		<input checked="" type="checkbox"/>

Schedule K-3 (Form 1120-S) 2025 Page 2

Corporation's name **Greener Pastures, Inc.** EIN **31-2345678** Shareholder's name **Nate** Shareholder's identifying number **xxx-xx-xxx1**

**Part I Shareholder's Share of Corporation's Other Current Year International Information**

Check boxes for additional specified attachments. See instructions.

1. Gain on personal property sale  5. High-taxed income  8. Form 5471 information  11. Treaty treatment for certain S corporations  
 2. Foreign oil and gas taxes  6. Section 267A disallowed deduction  9. Other forms  12. Form 8865 information  
 3. Splitter arrangements  7. Form 8858 information  10. Shareholder loan transactions  13. Other international items (attach description and statement)  
 4. Foreign tax translation

**Part II Foreign Tax Credit Limitation**

**Section 1—Gross Income**

Description	(a) U.S. source	Foreign Source				(f) Sourced by shareholder	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code)		
1 Sales							
A US	<b>146,025</b>					<b>146,025</b>	
B							
C							
2 Gross income from performance of services							
A US	<b>158,565</b>					<b>158,565</b>	

Schedule K-3 (Form 1120-S) 2025 Page 3

Corporation's name **Greener Pastures, Inc.** EIN **31-2345678** Shareholder's name **Nate** Shareholder's identifying number **xxx-xx-xxx1**

**Part II Foreign Tax Credit Limitation (continued)**

**Section 1—Gross Income (continued)**

Description	(a) U.S. source	Foreign Source				(f) Sourced by shareholder	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code)		
8 Qualified dividends							
A MO			<b>366</b>			<b>366</b>	

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Schedule K-3 (Form 1120-S) 2025 Page 4

Corporation's name: **Greener Pastures, Inc.** EIN: **31-2345678** Shareholder's name: **Nate** Shareholder's identifying number: **xxx-xx-xxx1**

**Part II Foreign Tax Credit Limitation (continued)**  
Section 1—Gross Income (continued)

Description	(a) U.S. source	Foreign Source				(f) Sourced by shareholder	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other category code		
24 Total gross income (combine lines 1 through 23)	304,590		366				304,956
A US	304,590						304,590
B MO			366				366
C							

Schedule K-3 (Form 1120-S) 2025

Schedule K-3 (Form 1120-S) 2025 Page 5

Corporation's name: **Greener Pastures, Inc.** EIN: **31-2345678** Shareholder's name: **Nate** Shareholder's identifying number: **xxx-xx-xxx1**

**Part II Foreign Tax Credit Limitation (continued)**  
Section 2—Deductions

Description	(a) U.S. source	Foreign Source				(f) Sourced by shareholder	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other category code		
25 Expenses allocable to sales income	198,193						198,193
26 Expenses allocable to gross income from performance of services	85,866						85,866
27 Net short-term capital loss							
37 Depreciation not included on line 33 or line 35	9,106						9,106
38 Charitable contributions							
39 Interest expense specifically allocable under Regulations section 1.861-10(e)							
40 Other interest expense specifically allocable under Regulations section 1.861-10T							
41 Other interest expense—business					867		867
42 Other interest expense—investment							
43 Other interest expense—passive activity							
44 Section 59(a)(2) expenditures, excluding R&E expenses on line 32							
45 Foreign taxes not creditable but deductible							

Schedule K-3 (Form 1120-S) 2025

Schedule K-3 (Form 1120-S) 2025 Page 6

Corporation's name: **Greener Pastures, Inc.** EIN: **31-2345678** Shareholder's name: **Nate** Shareholder's identifying number: **xxx-xx-xxx1**

**Part II Foreign Tax Credit Limitation (continued)**  
Section 2—Deductions (continued)

Description	(a) U.S. source	Foreign Source				(f) Sourced by shareholder	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other category code		
54 Total deductions (combine lines 25 through 53)	293,165				867		294,032
55 Net income (loss) (subtract line 54 from line 24)	11,425		366		(867)		10,924

Schedule K-3 (Form 1120-S) 2025 Page 8

Corporation's name: **Greener Pastures, Inc.** EIN: **31-2345678** Shareholder's name: **Nate** Shareholder's identifying number: **xxx-xx-xxx1**

**Part III Other Information for Preparation of Form 1116 (continued)**  
Section 3—Foreign Taxes

Description	(a) Type of tax	(b) Section 951A category income		(c) Foreign branch category income		Shareholder
		U.S.	Foreign	U.S.	Foreign	
1 Direct (section 901 or 903) foreign taxes: <input checked="" type="checkbox"/> Paid <input type="checkbox"/> Accrued	WHTD					
A MO						
B						

Schedule K-3 (Form 1120-S) 2025 Page 9

Corporation's name: **Greener Pastures, Inc.** EIN: **31-2345678** Shareholder's name: **Nate** Shareholder's identifying number: **xxx-xx-xxx1**

**Part III Other Information for Preparation of Form 1116 (continued)**  
Section 3—Foreign Taxes (continued)

	(d) Passive category income			(e) General category income			(f) Other category code	(g) Total
	U.S.	Foreign	Shareholder	U.S.	Foreign	Shareholder		
1								
A	54							54
B								

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Department of the Treasury—Internal Revenue Service

Form **1040** U.S. Individual Income Tax Return **2025** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2025, or other tax year beginning , 2025, ending , 20 See separate instructions.

Filed pursuant to section 301.9100-2  Combat zone  Deceased MM / DD / YYYY Spouse MM / DD / YYYY

Other

Your first name and middle initial: **Nate** Last name: Last name: Your social security number: **xxx-xx-xxx1**

If joint return, spouse's first name and middle initial: Last name: Spouse's social security number:

Home address (number and street). If you have a P.O. box, see instructions. Apt. no. Check here if your main home, and your spouse's if filing a joint return, was in the U.S. for more than half of 2025.

City, town, or post office. If you have a foreign address, also complete spaces below. State: ZIP code: Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund.  You  Spouse

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

Filing Status  Single  Head of household (HOH)

Name, instructions, and attach schedule information required.

**Digital Assets** At any time during 2025, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.)  Yes  No

**Income**

1a Total amount from Form(s) W-2, box 1 (see instructions)	1a	58,455
b Household employee wages not reported on Form(s) W-2	1b	
c Tip income not reported on line 1a (see instructions)	1c	
d Medicaid waiver payments not reported on Form(s) W-2 (see instructions)	1d	
e Taxable dependent care benefits from Form 2441, line 26	1e	
f Employer-provided adoption benefits from Form 8839, line 31	1f	
g Wages from Form 8919, line 6	1g	
h Other earned income (see instructions). Enter type and amount:	1h	
i Nontaxable combat pay election (see instructions)	1i	
z Add lines 1a through 1h	1z	58,455
2a Tax-exempt interest	2a	
3a Qualified dividends	3a	366
c Check if your child's dividends are included in <input type="checkbox"/> Line 3a		
4a IRA distributions	4a	
c Check if (see instructions) <input type="checkbox"/> 1 <input type="checkbox"/> Rollover		
5a Pensions and annuities	5a	
c Check if (see instructions) <input type="checkbox"/> 1 <input type="checkbox"/> Rollover		
6a Social security benefits	6a	
c If you elect to use the lump-sum election method, check here (see instructions) <input type="checkbox"/>		
d If you are married filing separately and lived apart from your spouse the entire year (see inst.), check here <input type="checkbox"/>		
7a Capital gain or (loss). Attach Schedule D if required	7a	
b Check if: <input type="checkbox"/> Schedule D not required <input type="checkbox"/> Includes child's capital gain or (loss)		
8 Additional income from Schedule 1, line 10	8	10,557
9 Add lines 1z, 2b, 3b, 4b, 5b, 6b, 7a, and 8. This is your total income	9	69,378
10 Adjustments to income from Schedule 1, line 26	10	8,200
11a Subtract line 10 from line 9. This is your adjusted gross income	11a	61,178

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Form 1040 (2025) Page 2

**Tax and Credits**

11b Amount from line 11a (adjusted gross income)	11b	61,178
12a Someone can claim <input type="checkbox"/> You as a dependent <input type="checkbox"/> Your spouse as a dependent		
b <input type="checkbox"/> Spouse itemizes on a separate return c <input type="checkbox"/> You were a dual-status alien		
d You: <input type="checkbox"/> Were born before January 2, 1961 <input type="checkbox"/> Are blind		
Spouse: <input type="checkbox"/> Was born before January 2, 1961 <input type="checkbox"/> Is blind		
e Standard deduction or itemized deductions (from Schedule A)	12e	15,750
13a Qualified business income deduction from Form 8995 or Form 8995-A	13a	1,331
b Additional deductions from Schedule 1-A, line 38	13b	
14 Add lines 12e, 13a, and 13b	14	17,081
15 Subtract line 14 from line 11b. If zero or less, enter -0-. This is your taxable income	15	40,097
16 Tax (see instructions). Check if any from Form(s): 1 <input type="checkbox"/> 8814 2 <input type="checkbox"/> 4972 3 <input type="checkbox"/>	16	
17 Amount from Schedule 2, line 3	17	
18 Add lines 16 and 17	18	
19 Child tax credit or credit for other dependents from Schedule 8812	19	

Standard deduction for—Single or Married filing separately, \$15,750 Married filing jointly or Qualifying surviving spouse, \$31,500 Head of household,

Schedule E (Form 1040) 2025 Attachment Sequence No. 13 Page 2

Name(s) shown on return. Do not enter name and social security number if shown on other side. **Your social security number xxx-xx-xxxx1**

**Part II Income or Loss From Partnerships and S Corporations**

**27** Are you reporting any loss not allowed in a prior year due to the at-risk 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

	(a) Name	(b) Enter P for partnership, S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
A	Greener Pastures, Inc.	S	<input type="checkbox"/>	31-2345678	<input checked="" type="checkbox"/>	<input type="checkbox"/>
B			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
C			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
D			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>

Passive Income and Loss		Nonpassive Income and Loss	
(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562
A			5,500
B			
C			
D			
29a Totals			16,057
29b Totals			5,500
30 Add columns (h) and (k) of line 29a			30 16,057
31 Add columns (g), (i), and (j) of line 29b			31 ( 5,500 )
32 Total partnership and S corporation income or (loss). Combine lines 30 and 31			32 10,557

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

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

Passive Income and Loss		Nonpassive Income and Loss	
(c) Passive deduction or loss allowed (attach Form 8582 if required)	(d) Passive income from Schedule K-1	(e) Deduction or loss from Schedule K-1	(f) Other income from Schedule K-1
A			
B			
34a Totals			
34b Totals			
35 Add columns (d) and (f) of line 34a			35
36 Add columns (c) and (e) of line 34b			36 ( )
37 Total estate and trust income or (loss). Combine lines 35 and 36			37

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

(a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules Q, line 2c (see instructions)	(d) Taxable income (net loss) from Schedules Q, line 1b	(e) Income from Schedules Q, line 3b
38				
39 Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below				39

**Part V Summary**

40 Net farm rental income or (loss) from Form 4835. Also, complete line 42 below	40	
41 Total income or (loss). Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Schedule 1 (Form 1040), line 5	41	10,557
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 1120-S), box 17, code AN; and Schedule K-1 (Form 1041), box 14, code F. See instructions	42	
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, Form 1040-SR, or Form 1040-NR from all rental real estate activities in which you materially participated under the passive activity loss rules	43	

Schedule E (Form 1040) 2025

SCHEDULE 1 (Form 1040) Additional Income and Adjustments to Income

OMB No. 1545-0074

2025 Attachment Sequence No. 01

Department of the Treasury Internal Revenue Service

Attach to Form 1040, 1040-SR, or 1040-NR. Go to www.irs.gov/Form1040 for instructions and the latest information.

Name(s) shown on Form 1040, 1040-SR, or 1040-NR **Your social security number xxx-xx-xxxx1**

**Part I Additional Income**

For 2025, enter the amount reported to you on Form(s) 1099-K that was included in error or for personal items sold at a loss

**Note:** The remaining amounts reported to you on Form(s) 1099-K should be reported elsewhere on your return depending on the nature of the transaction. See www.irs.gov/1099k.

1 Taxable refunds, credits, or offsets of state and local income taxes	1	
2a Alimony received	2a	
b Date of original divorce or separation agreement (see instructions):		
3 Business income or (loss). Attach Schedule C	3	
4 Other gains or (losses). Check if any from Form(s): <input type="checkbox"/> 4797 <input type="checkbox"/> 4684	4	
5 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	5	10,557
6 Farm income or (loss). Attach Schedule F	6	
7 Unemployment compensation. If you repaid a 2025 overpayment (see instructions), check here <input type="checkbox"/> and enter amount repaid:	7	
9 Total other income. Add lines 8a through 8z	9	
10 Combine lines 1 through 7 and 9. This is your additional income. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8	10	10,557

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Schedule 1 (Form 1040) 2025 Page 2

**Part II Adjustments to Income**

11 Educator expenses	11	
12 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	12	
13 Health savings account deduction. Attach Form 8889	13	4,300
14 Moving expenses for members of the Armed Forces. Attach Form 3903. If claiming only storage fees (see instructions), check here <input type="checkbox"/>	14	
15 Deductible part of self-employment tax. Attach Schedule SE	15	
16 Self-employed SEP, SIMPLE, and qualified plans	16	3,900
17 Self-employed health insurance deduction	17	
18 Penalty on early withdrawal of savings	18	
19a Alimony paid	19a	
b Recipient's SSN		
c Date of original divorce or separation agreement (see instructions):		
25 Total other adjustments. Add lines 24a through 24z	25	
26 Add lines 11 through 23 and 25. These are your adjustments to income. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 10	26	8,200

Schedule 1 (Form 1040) 2025

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Form <b>8995</b> Department of the Treasury Internal Revenue Service	<b>Qualified Business Income Deduction Simplified Computation</b> Attach to your tax return. Go to <a href="http://www.irs.gov/Form8995">www.irs.gov/Form8995</a> for instructions and the latest information.	OMB No. 1545-2294 <div style="text-align: center; font-size: 24pt; font-weight: bold;">2025</div> Attachment Sequence No. <b>55</b>	
Name(s) shown on return <b>Nate</b>		Your taxpayer identification number <b>xxx-xx-xxxx1</b>	
<p><b>Note:</b> You can claim the qualified business income deduction <b>only</b> if you have qualified business income from a qualified trade or business, real estate investment trust dividends, publicly traded partnership income, or a domestic production activities deduction passed through from an agricultural or horticultural cooperative. See instructions.                  Use this form if your taxable income, before your qualified business income deduction, is at or below \$197,300 (\$394,600 if married filing jointly), and you aren't a patron of an agricultural or horticultural cooperative.</p>			
	(a) Trade, business, or aggregation name	(b) Taxpayer identification number	(c) Qualified business income or (loss)
1			
i	<b>Greener Pastures, Inc.</b>	<b>31-2345678</b>	<b>6,657*</b>
ii			
iii			
iv			
v			
2	Total qualified business income or (loss). Combine lines 1i through 1v, column (c)	2 <b>6,657</b>	
3	Qualified business net (loss) carryforward from the prior year	3 ( )	
4	Total qualified business income. Combine lines 2 and 3. If zero or less, enter -0-	4 <b>6,657</b>	
5	Qualified business income component. Multiply line 4 by 20% (0.20)		5 <b>1,331</b>
6	Qualified REIT dividends and publicly traded partnership (PTP) income or (loss) (see instructions)	6 ( )	
7	Qualified REIT dividends and qualified PTP (loss) carryforward from the prior year	7 ( )	
8	Total qualified REIT dividends and PTP income. Combine lines 6 and 7. If zero or less, enter -0-	8 ( )	
9	REIT and PTP component. Multiply line 8 by 20% (0.20)		9 ( )
10	Qualified business income deduction before the income limitation. Add lines 5 and 9	10 <b>1,331</b>	
11	Taxable income before qualified business income deduction (see instructions)	11 <b>45,428</b>	
12	Enter your net capital gain, if any, increased by any qualified dividends (see instructions)	12 ( )	
13	Subtract line 12 from line 11. If zero or less, enter -0-	13 <b>45,428</b>	
14	Income limitation. Multiply line 13 by 20% (0.20)		14 <b>9,086</b>
15	Qualified business income deduction. Enter the smaller of line 10 or line 14. Also enter this amount on the applicable line of your return (see instructions)		15 <b>1,331</b>
16	Total qualified business (loss) carryforward. Combine lines 2 and 3. If greater than zero, enter -0-	16 ( )	
17	Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 6 and 7. If greater than zero, enter -0-	17 ( )	

*Qualified business income computation		
Type of income/deduction	Location	Amount
Business income	Schedule K-1, line 1	\$16,057
Section 179 deduction	Schedule K-1, line 11	(5,500)
Allocated deduction for SE health insurance	Schedule 1 (Form 1040), line 17	(3,900)
<b>Qualified business income</b>		<b>\$6,657</b>

Form <b>7203</b> (Rev. December 2022) Department of the Treasury Internal Revenue Service	<b>S Corporation Shareholder Stock and Debt Basis Limitations</b> Attach to your tax return. Go to <a href="http://www.irs.gov/Form7203">www.irs.gov/Form7203</a> for instructions and the latest information.	OMB No. 1545-2302 Attachment Sequence No. <b>203</b>		
Name of shareholder <b>Nate</b>		Identifying number <b>xxx-xx-xxxx1</b>		
A Name of S corporation <b>Greener Pastures, Inc.</b>		B Employer identification number <b>31-2345678</b>		
C Stock block (see instructions): <b>55,000 shares Greener Pastures, Inc.</b>				
D Check applicable box(es) to indicate how stock was acquired: (1) <input checked="" type="checkbox"/> Original shareholder (2) <input type="checkbox"/> Purchased (3) <input type="checkbox"/> Inherited (4) <input type="checkbox"/> Gift (5) <input type="checkbox"/> Other:				
E Check if you have a Regulations section 1.1367-1(g) election in effect during the tax year for this S corporation <input type="checkbox"/>				
<b>Part I Shareholder Stock Basis</b>				
	1 Stock basis at the beginning of the corporation's tax year		1	0
2	Basis from any capital contributions made or additional stock acquired during the tax year		2	55,000
3a	Ordinary business income (enter losses in Part III)	3a <b>16,057</b>		
3b	Net rental real estate income (enter losses in Part III)	3b ( )		
3c	Other net rental income (enter losses in Part III)	3c ( )		
3d	Interest income	3d ( )		
3e	Ordinary dividends	3e <b>366</b>		
3f	Royalties	3f ( )		
3g	Net capital gains (enter losses in Part III)	3g ( )		
3h	Net section 1231 gain (enter losses in Part III)	3h ( )		
3i	Other income (enter losses in Part III)	3i ( )		
3j	Excess depletion adjustment	3j ( )		
3k	Tax-exempt income	3k ( )		
3l	Recapture of business credits	3l ( )		
3m	Other items that increase stock basis	3m ( )		
4	Add lines 3a through 3m		4	16,423
5	Stock basis before distributions. Add lines 1, 2, and 4		5	71,423
6	Distributions (excluding dividend distributions)		6	5,500
<p><b>Note:</b> If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.</p>				
7	Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15		7	65,923
8a	Non deductible expenses	8a <b>413</b>		
8b	Depletion for oil and gas	8b ( )		
8c	Business credits (sections 50(c)(1) and (5))	8c ( )		
9	Add lines 8a through 8c		9	413
10	Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15		10	65,510
11	Allowable loss and deduction items. Enter the amount from line 47, column (c)		11	5,554
12	Debt basis restoration (see net increase in instructions for line 23)		12	
13	Other items that decrease stock basis		13	
14	Add lines 11, 12, and 13		14	5,554
15	<b>Stock basis at the end of the corporation's tax year.</b> Subtract line 14 from line 10. If the result is zero or less, enter -0-		15	59,956

Part III Shareholder Allowable Loss and Deduction Items					
Description	(a) Current year losses and deductions	(b) Carryover amounts (column (e)) from the previous year	(c) Allowable loss from stock basis	(d) Allowable loss from debt basis	(e) Carryover amounts
35 Ordinary business loss					
36 Net rental real estate loss					
37 Other net rental loss					
38 Net capital loss					
39 Net section 1231 loss					
40 Other loss					
41 Section 179 deductions	5,500		5,500		
42 Charitable contributions					
43 Investment interest expense					
44 Section 59(e)(2) expenditures					
45 Other deductions					
46 Foreign taxes paid or accrued	54		54		
47 <b>Total loss.</b> Add lines 35 through 46 for each column. Enter the total loss in column (c) on line 11 and enter the total loss in column (d) on line 30	5,554		5,554		