1995

Department of the Treasury
Internal Revenue Service

Instructions for Form 1120S

U.S. Income Tax Return for an S Corporation

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

Paperwork Reduction Act Notice

We ask for the information on these forms to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

The time needed to complete and file this form and related schedules will vary depending on individual circumstances. The estimated average times are:

Form	Recordkeeping	Learning about the law or the form	Preparing the form	Copying, assembling, and sending the form to the IRS
1120S	62 hr., 40 min.	20 hr., 8 min.	35 hr., 59 min.	4 hr., 1 min.
Sch. D (1120S)	9 hr., 20 min.	4 hr., 8 min.	9 hr., 7 min.	1 hr., 20 min.
Sch. K-1 (1120S)	14 hr., 50 min.	10 hr., 7 min.	14 hr., 31 min.	1 hr., 4 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making these forms simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **DO NOT** send the tax form to this address. Instead, see **Where To File** on page 2.

Contents

Voluntary Contributions To Reduce the Public Debt . . . 1
A Change To Note . . . 1
General Instructions . . . 1
Purpose of Form . . . 1
Who Must File . . . 1
Termination of Election . . . 2
When To File . . . 2
Period Covered . . . 2
Where To File . . . 2
Who Must Sign . . . 2
Accounting Methods . . . 2
Accounting Periods . . . 3
Rounding Off to Whole Dollars . . . 3
Recordkeeping . . . 3
Depositary Method of Tax Payment . . . 3
Estimated Tax . . . 3
Interest and Penalties . . . 3
Unresolved Tax Problems . . . 4
Other Forms, Returns, Schedules, and Statements That May Be Required . . . 4
Attachments . . . 5
Amended Return . . . 5
Passive Activity Limitations . . . 5
Specific Instructions . . . 9
General Information . . . 9
Income . . . 9
Deductions . . . 10
Tax and Payments . . . 13
Schedule A—Cost of Goods Sold . . . 14
Schedule B—Other Information . . . 14
Designation of Tax Matters Person (TMP) . . . 15
General Instructions for Schedules K and K-1 . . . 15
Purpose of Schedules . . . 15
Substitute Forms . . . 15
Shareholder's Pro Rata Share Items . . . 15
Specific Instructions (Schedule K Only) . . . 15
Specific Instructions (Schedule K-1 Only) . . . 16
General Information . . . 16
Special Reporting Requirements for Corporations With Multiple Activities . . . 16
Special Reporting Requirements for At-Risk Activities . . . 16
Specific Items . . . 16
Specific Instructions (Schedules K and K-1, Except as Noted) . . . 16
Income (Loss) . . . 16
Deductions . . . 17
Investment Interest . . . 18
Credits . . . 18
Adjustments and Tax Preference Items . . . 19
Foreign Taxes . . . 20
Other . . . 21
Supplemental Information . . . 21
Specific Instructions . . . 22
Schedule L—Balance Sheets . . . 22
Schedule M-1—Reconciliation of Income (Loss) per Books With Income (Loss) per Return . . . 22
Schedule M-2—Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed . . . 22
Codes for Principal Business Activity . . . 24

Voluntary Contributions To Reduce the Public Debt

Quite often, inquiries are received about how to make voluntary contributions to reduce the public debt. A corporation may contribute by enclosing with the tax return a check made payable to "Bureau of the Public Debt."

A Change To Note

Final regulations under section 263A(f) have been issued on the capitalization of interest expense paid or incurred during the production period of certain property. Regulations sections 1.263A-8 through 1.263A-15, which generally are effective for tax years beginning after 1994, may require a change in accounting method. Any such change must be made under Rev. Proc. 95-19, 1995-12 I.R.B. 6.

General Instructions

Note: *In addition to the publications listed throughout these instructions, you may wish to get* ***Pub. 334,*** *Tax Guide for Small Business;* ***Pub. 535,*** *Business Expenses;* ***Pub. 550,*** *Investment Income and Expenses;* ***Pub. 556,*** *Examination of Returns, Appeal Rights, and Claims for Refund; and* ***Pub. 589,*** *Tax Information on S Corporations.*

You can get these and other publications referenced throughout these instructions at most IRS offices. To order publications and forms, call 1-800-TAX-FORM (1-800-829-3676). If you have a personal computer and a modem, you can also get forms and publications electronically. For details, see page 34 of the Instructions for Form 1040.

Purpose of Form

Form 1120S is used to report the income, deductions, gains, losses, etc., of a domestic corporation that has elected to be an S corporation by filing **Form 2553,** Election by a Small Business Corporation, and whose election is in effect for the tax year.

Who Must File

A corporation must file Form 1120S if **(a)** it elected to be an S corporation by filing Form 2553, **(b)** the IRS accepted the election, and **(c)** the election remains in effect. Do not file Form 1120S until the corporation has been notified by the IRS that the election has been accepted.

Termination of Election

Once the election is made, it stays in effect until it is terminated. During the 5 years after the election is terminated, the corporation (or a successor corporation) may make another election on Form 2553 only with IRS consent. See Regulations section 1.1362-5 for more details.

An election terminates **automatically** in any of the following cases:

1. The corporation is no longer a small business corporation as defined in section 1361(b). The termination of an election in this manner is effective as of the day on which the corporation no longer meets the definition of a small business corporation. If the election terminates for this reason, attach to Form 1120S for the final year of the S corporation a statement notifying the IRS of the termination and the date it occurred.

2. The corporation, for each of three consecutive tax years, **(a)** has subchapter C earnings and profits and **(b)** derives more than 25% of its gross receipts from passive investment income as defined in section 1362(d)(3)(D). The election terminates on the first day of the first tax year beginning after the third consecutive tax year. The corporation must pay a tax for each year it has excess net passive income. See the instructions for line 22a for details on how to figure the tax.

3. The election is revoked. An election may be revoked only with the consent of shareholders who, at the time the revocation is made, hold more than 50% of the number of issued and outstanding shares of stock (including non-voting stock). The revocation may specify an effective revocation date that is on or after the day the revocation is filed. If no date is specified, the revocation is effective at the start of a tax year if the revocation is made on or before the 15th day of the 3rd month of that tax year. If no date is specified and the revocation is made after the 15th day of the 3rd month of the tax year, the revocation is effective at the start of the next tax year.

To revoke the election, the corporation must file a statement with the service center where it filed its election to be an S corporation. In the statement, the corporation must notify the IRS that it is revoking its election to be an S corporation. The statement must be signed by each shareholder who consents to the revocation and contain the information required by Regulations section 1.1362-6(a)(3). A revocation may be rescinded before the revocation takes effect. See Regulations section 1.1362-6(a)(4) for details.

For rules on allocating income and deductions between an S short year and a C short year and other special rules that apply when an election is terminated, see section 1362(e) and Regulations section 1.1362-3.

If an election was terminated under **1** or **2** above, and the corporation believes the termination was inadvertent, the corporation may request permission from the IRS to continue to be treated as an S corporation. See Regulations section 1.1362-4 for the specific requirements that must be met to qualify for inadvertent termination relief.

When To File

In general, file Form 1120S by the 15th day of the 3rd month following the date the corporation's tax year ended as shown at the top of Form 1120S. For calendar year corporations, the due date is March 15, 1996. If the due date falls on a Saturday, Sunday, or legal holiday, file on the next business day. A business day is any day that is not a Saturday, Sunday, or legal holiday.

If the S election was terminated during the tax year, file Form 1120S for the S short year by the due date (including extensions) of the C short year return.

Extension

Use **Form 7004,** Application for Automatic Extension of Time To File Corporation Income Tax Return, to request an automatic 6-month extension of time to file Form 1120S.

Period Covered

File the 1995 return for calendar year 1995 and fiscal years beginning in 1995 and ending in 1996. If the return is for a fiscal year or a short tax year, fill in the tax year space at the top of the form.

Note: *The 1995 Form 1120S may also be used if* ***(a)*** *the corporation has a tax year of less than 12 months that begins and ends in 1996 and* ***(b)*** *the 1996 Form 1120S is not available by the time the corporation is required to file its return. However, the corporation must show its 1996 tax year on the 1995 Form 1120S and incorporate any tax law changes that are effective for tax years beginning after December 31, 1995.*

Where To File

Use the preaddressed envelope. If you do not have the envelope, file your return at the applicable IRS address listed below.

If the corporation's principal business, office, or agency is located in	Use the following Internal Revenue Service Center address
New Jersey, New York (New York City and counties of Nassau, Rockland, Suffolk, and Westchester)	Holtsville, NY 00501-0013
New York (all other counties), Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont	Andover, MA 05501-0013
Florida, Georgia, South Carolina	Atlanta, GA 39901-0013
Indiana, Kentucky, Michigan, Ohio, West Virginia	Cincinnati, OH 45999-0013
Kansas, New Mexico, Oklahoma, Texas	Austin, TX 73301-0013
Alaska, Arizona, California (counties of Alpine, Amador, Butte, Calaveras, Colusa, Contra Costa, Del Norte, El Dorado, Glenn, Humboldt, Lake, Lassen, Marin, Mendocino, Modoc, Napa, Nevada, Placer, Plumas, Sacramento, San Joaquin, Shasta, Sierra, Siskiyou, Solano, Sonoma, Sutter, Tehama, Trinity, Yolo, and Yuba), Colorado, Idaho, Montana, Nebraska, Nevada, North Dakota, Oregon, South Dakota, Utah, Washington, Wyoming	Ogden, UT 84201-0013
California (all other counties), Hawaii	Fresno, CA 93888-0013
Illinois, Iowa, Minnesota, Missouri, Wisconsin	Kansas City, MO 64999-0013
Alabama, Arkansas, Louisiana, Mississippi, North Carolina, Tennessee	Memphis, TN 37501-0013
Delaware, District of Columbia, Maryland, Pennsylvania, Virginia	Philadelphia, PA 19255-0013

Who Must Sign

The return must be signed and dated by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or any other corporate officer (such as tax officer) authorized to sign. A receiver, trustee, or assignee must sign and date any return he or she is required to file on behalf of a corporation.

If a corporate officer filled in Form 1120S, the Paid Preparer's space under "Signature of officer" should remain blank. If someone prepares Form 1120S and does not charge the corporation, that person should not sign the return. Certain others who prepare Form 1120S should not sign. For example, a regular, full-time employee of the corporation such as a clerk, secretary, etc., should not sign.

Generally, anyone paid to prepare Form 1120S must sign the return and fill in the other blanks in the Paid Preparer's Use Only area of the return.

The preparer required to sign the return MUST complete the required preparer information and:

- Sign it, by hand, in the space provided for the preparer's signature. (Signature stamps or labels are not acceptable.)
- Give a copy of Form 1120S to the taxpayer in addition to the copy filed with the IRS.

Accounting Methods

Figure ordinary income using the method of accounting regularly used in keeping the corporation's books and records. Generally, permissible methods include the cash method, the accrual method, or any other method permitted by the Internal Revenue Code. In all cases, the method adopted must clearly reflect income.

Generally, an S corporation may not use the cash method of accounting if the corporation is a tax shelter (as defined in section 448(d)(3)). See section 448 for details.

Under the accrual method, an amount is includible in income when all the events have occurred that fix the right to receive the income and the amount can be determined with reasonable accuracy. See Regulations section 1.451-1(a) for details.

Generally, an accrual basis taxpayer can deduct accrued expenses in the tax year in which all events that determine liability have occurred, the amount of the liability can be figured with reasonable accuracy, and economic performance takes place with respect to the expense. There are exceptions for recurring items and items involving transactions between related taxpayers described in section 267.

Except for certain home construction contracts and other real property small construction contracts, long-term contracts must generally be accounted for using the percentage of completion method described in section 460.

Dealers in securities must use the "mark-to-market" accounting method described in section 475. Under this method, any security that is inventory to the dealer must be included in inventory at its fair market value. Any security that is not inventory and that is held at the close of the tax year is treated as sold at its fair market value on the last business day of the tax year, and any gain or loss must be taken into account in determining gross income. The gain or loss taken into account is generally treated as ordinary gain or loss. For details, including exceptions, see section 475.

Generally, the corporation may change its method of accounting used to report taxable income (for income as a whole or for any material item) only by getting consent on **Form 3115,** Application for Change in Accounting Method. For more information, get **Pub. 538,** Accounting Periods and Methods.

Accounting Periods

Generally, an S corporation may not change its accounting period to a tax year that is not a permitted year. A "permitted year" is a calendar year or any other accounting period for which the corporation can establish to the satisfaction of the IRS that there is a business purpose for the tax year.

To change an accounting period, see Regulations section 1.442-1 and **Form 1128,** Application to Adopt, Change, or Retain a Tax Year. Also see Pub. 538.

Election of a tax year other than a required year.—Under the provisions of section 444, an S corporation may elect to have a tax year other than a permitted year, but only if the deferral period of the tax year is not longer than 3 months. This election is made by filing **Form 8716,** Election To Have a Tax Year Other Than a Required Tax Year.

An S corporation may not make or continue an election under section 444 if it is a member of a tiered structure, other than a tiered structure that consists entirely of partnerships and S corporations that have the same tax year. For the S corporation to have a section 444 election in effect, it must make the payments required by section 7519 and file **Form 8752,** Required Payment or Refund Under Section 7519.

A section 444 election ends if an S corporation changes its accounting period to a calendar year or some other permitted year, it willfully fails to comply with the requirements of section 7519, or its S election is terminated (unless it immediately becomes a personal service corporation). If the termination results in a short tax year, type or legibly print at the top of the first page of Form 1120S for the short tax year, "SECTION 444 ELECTION TERMINATED."

Rounding Off to Whole Dollars

You may round off cents to whole dollars on your return and accompanying schedules. To do so, drop amounts under 50 cents and increase amounts from 50 to 99 cents to the next higher dollar.

Recordkeeping

The corporation's records must be kept as long as they may be needed for the administration of any provision of the Internal Revenue Code. If the consolidated audit procedures of sections 6241 through 6245 apply to the corporation, records that support an item of income, deduction, or credit on the corporation's return usually must be kept for 3 years from the date the return is due or is filed, whichever is later. If the consolidated audit procedures do not apply, these records usually must be kept for 3 years from the date each shareholder's return is due or is filed, whichever is later. Keep records that verify the corporation's basis in property for as long as they are needed to figure the basis of the original or replacement property.

The corporation should also keep copies of any returns it has filed. They help in preparing future returns and in making computations when filing an amended return.

Depositary Method of Tax Payment

The corporation must pay the tax due in full no later than the 15th day of the 3rd month after the end of the tax year.

Deposit corporation income tax payments (and estimated tax payments) with **Form 8109,** Federal Tax Deposit Coupon. Do not submit deposits directly to an IRS office; otherwise, the corporation may have to pay a penalty. Mail or deliver the completed Form 8109 with the payment to a qualified depositary for Federal taxes or to the Federal Reserve bank (FRB) servicing your geographic area. Make your checks or money orders payable to that depositary or FRB.

To help ensure proper crediting, write the corporation's employer identification number, the tax period to which the deposit applies, and "Form 1120S" on your check or money order. Be sure to darken the "1120" box on the coupon. These records of deposit will be sent to the IRS.

For more information on deposits, see the instructions in the coupon booklet (Form 8109) and **Pub. 583,** Starting a Business and Keeping Records.

Estimated Tax

Generally, the corporation must make estimated tax payments for the following taxes if the total of these taxes is $500 or more: **(a)** the tax on certain capital gains, **(b)** the tax on built-in gains, **(c)** the excess net passive income tax, and **(d)** the investment credit recapture tax.

The amount of estimated tax required to be paid annually is the lesser of **(a)** the total of the above taxes shown on the return for the tax year (or if no return is filed, the total of these taxes for the year); or **(b)** the sum of **(i)** the investment credit recapture tax and the built-in gains tax (or the tax on certain capital gains) shown on the return for the tax year (or if no return is filed, the total of these taxes for the year), and **(ii)** any excess net passive income tax shown on the corporation's return for the preceding tax year. If the preceding tax year was less than 12 months, the estimated tax must be determined under **(a).**

The estimated tax is generally payable in four equal installments. However, the corporation may be able to lower the amount of one or more installments by using the annualized income installment method or adjusted seasonal installment method under section 6655(e).

For a calendar year corporation, the payments are due for 1996 by April 15, June 17, September 16, and December 16. For a fiscal year corporation, they are due by the 15th day of the 4th, 6th, 9th, and 12th months of the fiscal year.

The corporation must make the payments using the depositary method described above.

Interest and Penalties

Interest

Interest is charged on taxes not paid by the due date, even if an extension of time to file is granted. Interest is also charged from the due date (including extensions) to the date of payment on the failure to file penalty, the accuracy-related penalty, and the fraud penalty. The interest charge is figured at a rate determined under section 6621.

Late Filing of Return

A corporation that does not file its tax return by the due date, including extensions, may have to pay a penalty of 5% a month, or part of a month, up to a

maximum of 25%, for each month the return is not filed. The penalty is imposed on the net amount due. The minimum penalty for filing a return more than 60 days late is the smaller of the tax due or $100. The penalty will not be imposed if the corporation can show that the failure to file on time was due to reasonable cause. If the failure is due to reasonable cause, attach an explanation to the return.

Late Payment of Tax

A corporation that does not pay the tax when due generally may have to pay a penalty of ½ of 1% a month or part of a month, up to a maximum of 25%, for each month the tax is not paid. The penalty is imposed on the net amount due.

The penalty will not be imposed if the corporation can show that failure to pay on time was due to reasonable cause.

Failure To Furnish Information Timely

Section 6037(b) requires an S corporation to furnish to each shareholder a copy of the information shown on Schedule K-1 (Form 1120S) that is attached to Form 1120S. Provide Schedule K-1 to each shareholder on or before the day on which the corporation files Form 1120S.

For each failure to furnish Schedule K-1 to a shareholder when due and each failure to include on Schedule K-1 all the information required to be shown (or the inclusion of incorrect information), a $50 penalty may be imposed with regard to each Schedule K-1 for which a failure occurs. If the requirement to report correct information is intentionally disregarded, each $50 penalty is increased to $100 or, if greater, 10% of the aggregate amount of items required to be reported. See sections 6722 and 6724 for more information.

The penalty will not be imposed if the corporation can show that not furnishing information timely was due to reasonable cause and not due to willful neglect.

Unresolved Tax Problems

The IRS has a Problem Resolution Program for taxpayers who have been unable to resolve their problems with the IRS. If the corporation has a tax problem it has been unable to resolve through normal channels, write to the corporation's local IRS District Director or call the corporation's local IRS office and ask for Problem Resolution assistance. Hearing-impaired persons who have access to TDD equipment may call 1-800-829-4059 to ask for help. The Problem Resolution office will ensure that your problem receives proper attention. Although the office cannot change the tax law or make technical decisions, it can help clear up problems that resulted from previous contacts.

Other Forms and Statements That May Be Required

- **Forms W-2** and **W-3,** Wage and Tax Statement; and Transmittal of Income and Tax Statements.

- **Form 720,** Quarterly Federal Excise Tax Return. Use Form 720 to report environmental excise taxes, communications and air transportation taxes, fuel taxes, luxury tax on passenger vehicles, manufacturers taxes, ship passenger tax, and certain other excise taxes.

Caution: *See **Trust fund recovery penalty** on page 5.*

- **Form 940** or **Form 940-EZ,** Employer's Annual Federal Unemployment (FUTA) Tax Return. The corporation may be liable for FUTA tax and may have to file Form 940 or 940-EZ if it paid wages of $1,500 or more in any calendar quarter during the calendar year (or the preceding calendar year) or one or more employees worked for the corporation for some part of a day in any 20 different weeks during the calendar year (or the preceding calendar year). A corporate officer who performs substantial services is considered an employee. Except as provided in section 3306(a), reasonable compensation for these services is subject to FUTA tax, no matter what the corporation calls the payments.

- **Form 941,** Employer's Quarterly Federal Tax Return. Employers must file this form quarterly to report income tax withheld on wages and employer and employee social security and Medicare taxes. A corporate officer who performs substantial services is considered an employee. Except as provided in sections 3121(a) and 3401(a), reasonable compensation for these services is subject to employer and employee social security and Medicare taxes and income tax withholding, no matter what the corporation calls the payments. Agricultural employers must file **Form 943,** Employer's Annual Tax Return for Agricultural Employees, instead of Form 941, to report income tax withheld and employer and employee social security and Medicare taxes on farmworkers.

Caution: *See **Trust fund recovery penalty** on page 5.*

- **Form 945,** Annual Return of Withheld Federal Income Tax. Use this form to report income tax withheld from nonpayroll payments, including pensions, annuities, IRAs, gambling winnings, and backup withholding.

Caution: *See **Trust fund recovery penalty** on page 5.*

- **Form 966,** Corporate Dissolution or Liquidation.

- **Forms 1042** and **1042-S,** Annual Withholding Tax Return for U.S. Source Income of Foreign Persons; and Foreign Person's U.S. Source Income Subject to Withholding. Use these forms to report and transmit withheld tax on payments made to nonresident alien individuals, foreign partnerships, or foreign corporations to the extent such payments constitute gross income from sources within the United States (see sections 861 through 865). For more information, see sections 1441 and 1442, and **Pub. 515,** Withholding of Tax on Nonresident Aliens and Foreign Corporations.

- **Form 1096,** Annual Summary and Transmittal of U.S. Information Returns.

- **Form 1098,** Mortgage Interest Statement. Use this form to report the receipt from any individual of $600 or more of mortgage interest and points in the course of the corporation's trade or business.

- **Forms 1099-A, B, DIV, INT, MISC, OID, PATR, R,** and **S.** You may have to file these information returns to report abandonments; acquisitions through foreclosure; proceeds from broker and barter exchange transactions; certain dividends; interest payments; medical and dental health care payments; miscellaneous income payments; original issue discount; patronage dividends; distributions from pensions, annuities, retirement or profit-sharing plans, IRAs, insurance contracts, etc.; and proceeds from real estate transactions. Also use certain of these returns to report amounts that were received as a nominee on behalf of another person.

Use Form 1099-DIV to report actual dividends paid by the corporation. Only distributions from accumulated earnings and profits are classified as dividends. Do not issue Form 1099-DIV for dividends received by the corporation that are allocated to shareholders on line 4b of Schedule K-1.

For more information, see the separate **Instructions for Forms 1099, 1098, 5498, and W-2G.**

Note: *Every corporation must file Forms 1099-MISC if it makes payments of rents, commissions, or other fixed or determinable income (see section 6041) totaling $600 or more to any one person in the course of its trade or business during the calendar year.*

- **Form 5713,** International Boycott Report. Every corporation that had operations in, or related to, a "boycotting" country, company, or national of a country must file Form 5713. In addition, persons who participate in or cooperate with an international boycott may have to complete Schedule A or Schedule B and Schedule C of Form 5713 to figure their loss of the foreign tax credit, the deferral of earnings of a controlled foreign corporation, IC-DISC benefits, and FSC benefits.

- **Form 8264,** Application for Registration of a Tax Shelter. Tax shelter organizers must file Form 8264 to register tax shelters with the IRS for the purpose of receiving a tax shelter registration number.

- **Form 8271,** Investor Reporting of Tax Shelter Registration Number. Corporations that have acquired an interest in a tax shelter that is required to be registered use Form 8271 to report the tax shelter's registration number. Attach Form 8271 to any return on which a deduction, credit, loss, or other tax benefit attributable to a

tax shelter is taken or any income attributable to a tax shelter is reported.

- **Form 8275,** Disclosure Statement. File Form 8275 to disclose items or positions, except those contrary to a regulation, that are not otherwise adequately disclosed on a tax return. The disclosure is made to avoid the parts of the accuracy-related penalty imposed for disregard of rules or substantial understatement of tax. Form 8275 is also used for disclosures relating to preparer penalties for understatements due to unrealistic positions or disregard of rules.
- **Form 8275-R,** Regulation Disclosure Statement, is used to disclose any item on a tax return for which a position has been taken that is contrary to Treasury regulations.
- **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments. This form is used by issuers of publicly offered debt instruments having OID to provide the information required by section 1275(c).
- **Forms 8288** and **8288-A,** U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests; and Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests. Use these forms to report and transmit withheld tax on the sale of U.S. real property by a foreign person. See section 1445 and the related regulations for additional information.
- **Form 8300,** Report of Cash Payments Over $10,000 Received in a Trade or Business. File this form to report the receipt of more than $10,000 in cash or foreign currency in one transaction (or a series of related transactions).
- **Form 8594,** Asset Acquisition Statement. Both the purchaser and seller of a group of assets constituting a trade or business must file this form if section 197 intangibles attach, or could attach, to such assets and if the purchaser's basis in the assets is determined only by the amount paid for the assets.
- **Form 8697,** Interest Computation Under the Look-Back Method for Completed Long-Term Contracts. Certain S corporations that are not closely held may have to file Form 8697. Form 8697 is used to figure the interest due or to be refunded under the look-back method of section 460(b)(2) on certain long-term contracts that are accounted for under either the percentage of completion-capitalized cost method or the percentage of completion method. Closely held corporations should see the instructions on page 22 for line 23, item 10, of Schedule K-1 for details on the Form 8697 information they must provide to their shareholders.

Stock ownership in foreign corporations.—If the corporation owned at least 5% in value of the outstanding stock of a foreign personal holding company, and the corporation was required to include in its gross income any undistributed foreign personal holding company income, attach the statement required by section 551(c).

A corporation may have to file **Form 5471,** Information Return of U.S. Persons With Respect to Certain Foreign Corporations, if any of the following applies:

1. It controls a foreign corporation.

2. It acquires, disposes of, or owns 5% or more in value of the outstanding stock of a foreign corporation.

3. It is a 10%-or-more shareholder of a foreign personal holding company.

4. It owns stock in a controlled foreign corporation for an uninterrupted period of 30 days or more during any tax year of the foreign corporation, and it owned that stock on the last day of that year.

Transfers to a corporation controlled by the transferor.—If a person receives stock of a corporation in exchange for property, and no gain or loss is recognized under section 351, the transferor and transferee must each attach to their tax returns the information required by Regulations section 1.351-3.

Trust fund recovery penalty.—This penalty may apply if certain excise, income, social security, and Medicare taxes that must be collected or withheld are not collected or withheld, or these taxes are not paid to the IRS. These taxes are generally reported on Forms 720, 941, 943, or 945. The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to have been **responsible** for collecting, accounting for, and paying over these taxes, and who acted willfully in not doing so. The penalty is equal to the unpaid trust fund tax. See the instructions for Form 720, **Pub. 15 (Circular E),** Employer's Tax Guide, or **Pub. 51 (Circular A),** Agricultural Employer's Tax Guide, for more details, including the definition of responsible persons.

Attachments

Attach **Form 4136,** Credit for Federal Tax Paid on Fuels, after page 4, Form 1120S. Attach schedules in alphabetical order and other forms in numerical order after Form 4136.

To assist us in processing the return, **please complete every applicable entry space on Form 1120S and Schedule K-1.** If you attach statements, do not write "See attached" instead of completing the entry spaces on Form 1120S and Schedule K-1.

If you need more space on the forms or schedules, attach separate sheets. Use the same size and format as on the printed forms. **But show the totals on the printed forms.** Attach these separate sheets after all the schedules and forms. Be sure to put the corporation's name and employer identification number (EIN) on each sheet.

Amended Return

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

Note: *If an S corporation does not meet the small S corporation exception under Temporary Regulations section 301.6241-1T or if it is a small S corporation that has made the election described in Temporary Regulations section 301.6241-1T(c)(2)(v), and it files an amended return, the amended return will be a request for administrative adjustment and the tax matters person must file* ***Form 8082,*** *Notice of Inconsistent Treatment or Amended Return (Administrative Adjustment Request (AAR)). See the temporary regulations under section 6241 for more information.*

A change to the corporation's Federal return may affect its state return. This includes changes made as the result of an IRS examination of Form 1120S. For more information, contact the state tax agency for the state in which the corporation's return was filed.

Passive Activity Limitations

In general, section 469 limits the amount of losses, deductions, and credits that shareholders may claim from "passive activities." The passive activity limitations do not apply to the corporation. Instead, they apply to each shareholder's share of any income or loss and credit attributable to a passive activity. Because the treatment of each shareholder's share of corporate income or loss and credit depends upon the nature of the activity that generated it, the corporation must report income or loss and credits separately for each activity.

The instructions below (pages 5 through 9) and the instructions for Schedules K and K-1 (pages 15 through 22) explain the applicable passive activity limitation rules and specify the type of information the corporation must provide to its shareholders for each activity. If the corporation had more than one activity, it must report information for each activity on an attachment to Schedules K and K-1.

Generally, passive activities include **(a)** activities that involve the conduct of a trade or business in which the shareholder does not materially participate and **(b)** any rental activity (defined on page 6) even if the shareholder materially participates. For exceptions, see **Activities That Are Not Passive Activities** on page 6. The level of each shareholder's participation in an activity must be determined by the shareholder.

The passive activity rules provide that losses and credits from passive activities can generally be applied only against income and tax from passive activities. Thus, passive losses and credits cannot be applied against income from salaries, wages, professional fees, or a business in which the shareholder materially participates; against "portfolio income"

(defined on page 7); or against the tax related to any of these types of income.

Special rules require that net income from certain activities that would otherwise be treated as passive income must be recharacterized as nonpassive income for purposes of the passive activity limitations.

To allow each shareholder to apply the passive activity limitations at the individual level, the corporation must report income or loss and credits separately for each of the following: trade or business activities, rental real estate activities, rental activities other than rental real estate, and portfolio income.

Activities That Are Not Passive Activities

Passive activities do not include:

1. Trade or business activities in which the shareholder materially participated for the tax year.

2. Any rental real estate activity in which the shareholder materially participated and met both of the following conditions for the tax year:

a. More than half of the personal services the shareholder performed in trades or businesses were performed in real property trades or businesses in which he or she materially participated, and

b. The shareholder performed more than 750 hours of services in real property trades or businesses in which he or she materially participated.

For purposes of this rule, each interest in rental real estate is a separate activity unless the shareholder elects to treat all interests in rental real estate as one activity.

If the shareholder is married filing jointly, either the shareholder or his or her spouse must separately meet both of the above conditions, without taking into account services performed by the other spouse.

A real property trade or business is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Services the shareholder performed as an employee are not treated as performed in a real property trade or business unless he or she owned more than 5% of the stock in the employer.

3. The rental of a dwelling unit used by a shareholder for personal purposes during the year for more than the greater of 14 days or 10% of the number of days that the residence was rented at fair rental value.

4. An activity of trading personal property for the account of owners of interests in the activity. See Temporary Regulations section 1.469-1T(e)(6).

Note: *The section 469(c)(3) exception for a working interest in oil and gas properties is not applicable to an S corporation because state law generally limits the liability of corporate shareholders.*

Trade or Business Activities

A trade or business activity is an activity (other than a rental activity or an activity treated as incidental to an activity of holding property for investment) that—

1. Involves the conduct of a trade or business (within the meaning of section 162),

2. Is conducted in anticipation of starting a trade or business, or

3. Involves research or experimental expenditures deductible under section 174 (or that would be if you chose to deduct rather than capitalize them).

If the shareholder does not materially participate in the activity, a trade or business activity of the corporation is a passive activity for the shareholder.

Each shareholder must determine if he or she materially participated in an activity. As a result, while the corporation's overall trade or business income (loss) is reported on page 1 of Form 1120S, the specific income and deductions from each separate trade or business activity must be reported on attachments to Form 1120S. Similarly, while each shareholder's allocable share of the corporation's overall trade or business income (loss) is reported on line 1 of Schedule K-1, each shareholder's allocable share of the income and deductions from each trade or business activity must be reported on attachments to each Schedule K-1. See **Passive Activity Reporting Requirements** on page 8 for more information.

Rental Activities

Generally, except as noted below, if the gross income from an activity consists of amounts paid principally for the use of real or personal tangible property held by the corporation, the activity is a rental activity.

There are several exceptions to this general rule. Under these exceptions, an activity involving the use of real or personal tangible property is not a rental activity if **(a)** the average period of customer use (defined below) for such property is 7 days or less; **(b)** the average period of customer use for such property is 30 days or less and significant personal services (defined below) are provided by or on behalf of the corporation; **(c)** extraordinary personal services (defined below) are provided by or on behalf of the corporation; **(d)** rental of the property is treated as incidental to a nonrental activity of the corporation under Temporary Regulations section 1.469-1T(e)(3)(vi) and Regulations section 1.469-1(e)(3)(vi); or **(e)** the corporation customarily makes the property available during defined business hours for nonexclusive use by various customers.

In addition, if the corporation provides property for use in a nonrental activity of a partnership in its capacity as an owner of an interest in such partnership, the provision of the property is not a rental activity. Consequently, the corporation's distributive share of income from the activity is not income from a rental activity. A guaranteed payment described in section 707(c) is not income from a rental activity under any circumstances. Whether the corporation provides property used in an activity of a partnership in the corporation's capacity as an owner of an interest in the partnership is based on all the facts and circumstances.

Average period of customer use.— Figure the average period of customer use of property by dividing the total number of days in all rental periods by the number of rentals during the tax year. If the activity involves renting more than one class of property, multiply the average period of customer use of each class by the ratio of the gross rental income from that class to the activity's total gross rental income. The activity's average period of customer use equals the sum of these class-by-class average periods weighted by gross income. See Regulations section 1.469-1(e)(3)(iii).

Significant personal services.—Personal services include only services performed by individuals. In determining whether personal services are significant personal services, consider all of the relevant facts and circumstances. Relevant facts and circumstances include how often the services are provided, the type and amount of labor required to perform the services, and the value of the services in relation to the amount charged for the use of the property.

The following services are not considered in determining whether personal services are significant: **(a)** services necessary to permit the lawful use of the rental property; **(b)** services performed in connection with improvements or repairs to the rental property that extend the useful life of the property substantially beyond the average rental period; and **(c)** services provided in connection with the use of any improved real property that are similar to those commonly provided in connection with long-term rentals of high-grade commercial or residential property (e.g., cleaning and maintenance of common areas, routine repairs, trash collection, elevator service, and security at entrances).

Extraordinary personal services.— Services provided in connection with making rental property available for customer use are extraordinary personal services only if the services are performed by individuals and the customers' use of the rental property is incidental to their receipt of the services. For example, a patient's use of a hospital room generally is incidental to the care that the patient receives from the hospital's medical staff. Similarly, a student's use of a dormitory room in a boarding school is incidental to the personal services provided by the school's teaching staff.

Rental property incidental to a nonrental activity.—An activity is not a rental activity if the rental of the property is incidental to a nonrental activity, such as the activity of holding property for investment, a trade or business activity, or the activity of dealing in property.

Rental property is incidental to an activity of holding property for investment if

the main purpose for holding the property is to realize a gain from the appreciation of the property and the gross rental income from such property for the tax year is less than 2% of the smaller of the property's unadjusted basis or its fair market value.

Rental property is incidental to a trade or business activity if **(a)** the corporation owns an interest in the trade or business at all times during the year; **(b)** the rental property was mainly used in the trade or business activity during the tax year or during at least 2 of the 5 preceding tax years; and **(c)** the gross rental income from the property is less than 2% of the smaller of the property's unadjusted basis or its fair market value.

The sale or exchange of property that is also rented during the tax year (where the gain or loss is recognized) is treated as incidental to the activity of dealing in property if, at the time of the sale or exchange, the property was held primarily for sale to customers in the ordinary course of the corporation's trade or business.

See Temporary Regulations section 1.469-1T(e)(3) and Regulations section 1.469-1(e)(3) for more information on the definition of rental activities for purposes of the passive activity limitations.

Reporting of rental activities.—In reporting the corporation's income or losses and credits from rental activities, the corporation must separately report **(a)** rental real estate activities and **(b)** rental activities other than rental real estate activities.

Shareholders who actively participate in a rental real estate activity may be able to deduct part or all of their rental real estate losses (and the deduction equivalent of rental real estate credits) against income (or tax) from nonpassive activities. Generally, the combined amount of rental real estate losses and the deduction equivalent of rental real estate credits from all sources (including rental real estate activities not held through the corporation) that may be claimed is limited to $25,000.

Report rental real estate activity income (loss) on **Form 8825,** Rental Real Estate Income and Expenses of a Partnership or an S Corporation, and on line 2 of Schedules K and K-1 rather than on page 1 of Form 1120S. Report credits related to rental real estate activities on lines 12c and 12d and low-income housing credits on line 12b of Schedules K and K-1.

Report income (loss) from rental activities other than rental real estate on line 3 and credits related to rental activities other than rental real estate on line 12e of Schedules K and K-1.

Portfolio Income

Generally, portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business, that is attributable to interest; dividends; royalties; income from a real estate investment trust, a regulated investment company, a real estate mortgage investment conduit, a common trust fund, a controlled foreign corporation, a qualified electing fund, or a cooperative; income from the disposition of property that produces income of a type defined as portfolio income; and income from the disposition of property held for investment.

Solely for purposes of the preceding paragraph, gross income derived in the ordinary course of a trade or business includes **(and portfolio income, therefore, does not include)** only the following types of income: **(a)** interest income on loans and investments made in the ordinary course of a trade or business of lending money; **(b)** interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business; **(c)** income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies; **(d)** income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (unless the dealer held the property for investment at any time before such income or gain is recognized); **(e)** royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property; **(f)** amounts included in the gross income of a patron of a cooperative by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and **(g)** other income identified by the IRS as income derived by the taxpayer in the ordinary course of a trade or business.

See Temporary Regulations section 1.469-2T(c)(3) for more information on portfolio income.

Report portfolio income on line 4 of Schedules K and K-1, rather than on page 1 of Form 1120S.

Report expenses related to portfolio income on line 9 of Schedules K and K-1.

Grouping Activities

Generally, one or more trade or business activities or rental activities may be treated as a single activity if the activities make up an appropriate economic unit for measurement of gain or loss under the passive activity rules. Whether activities make up an appropriate economic unit depends on all the relevant facts and circumstances. The factors given the greatest weight in determining whether activities make up an appropriate economic unit are—

1. Similarities and differences in types of trades or businesses,

2. The extent of common control,

3. The extent of common ownership,

4. Geographical location, and

5. Reliance between or among the activities.

Example: The corporation has a significant ownership interest in a bakery and a movie theater in Baltimore and in a bakery and a movie theater in Philadelphia. Depending on the relevant facts and circumstances, there may be more than one reasonable method for grouping the corporation's activities. For instance, the following groupings may or may not be permissible: a single activity, a movie theater activity and a bakery activity, a Baltimore activity and a Philadelphia activity, or four separate activities.

Once the corporation chooses a grouping under these rules, it must continue using that grouping in later tax years unless a material change in the facts and circumstances makes it clearly inappropriate.

The IRS may regroup the corporation's activities if the corporation's grouping fails to reflect one or more appropriate economic units and one of the primary purposes for the grouping is to avoid the passive activity limitations.

Limitation on grouping certain activities.—The following activities may not be grouped together—

1. A rental activity with a trade or business activity unless the activities being grouped together make up an appropriate economic unit, and

a. The rental activity is insubstantial relative to the trade or business activity or vice versa, or

b. Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity. If so, the portion of the rental activity involving the rental of property to be used in the trade or business activity may be grouped with the trade or business activity.

2. An activity involving the rental of real property with an activity involving the rental of personal property (except for personal property provided in connection with real property), or vice versa.

3. Any activity with another activity in a different type of business and in which the corporation holds an interest as a limited partner or as a limited entrepreneur (as defined in section 464(e)(2)) if that other activity engages in holding, producing, or distributing motion picture films or videotapes; farming; leasing section 1245 property; or exploring for (or exploiting) oil and gas resources or geothermal deposits.

Activities conducted through partnerships.—Once a partnership determines its activities under these rules, the corporation as a partner may use these rules to group those activities with each other, with activities conducted directly by the corporation, and with activities conducted through other partnerships. The corporation may not treat as separate activities those activities grouped together by the partnership.

Recharacterization of Passive Income

Under Temporary Regulations section 1.469-2T(f) and Regulations section 1.469-2(f), net passive income from certain passive activities must be treated as nonpassive income. Net passive income is the excess of an activity's passive activity gross income over its passive activity

deductions (current year deductions and prior year unallowed losses).

Income from the following six sources is subject to recharacterization. Note that any net passive income recharacterized as nonpassive income is treated as investment income for purposes of figuring investment interest expense limitations if it is from **(a)** an activity of renting substantially nondepreciable property from an equity-financed lending activity or **(b)** an activity related to an interest in a pass-through entity that licenses intangible property.

1. Significant participation passive activities.—A significant participation passive activity is any trade or business activity in which the shareholder both participates for more than 100 hours during the tax year and does not materially participate. Because each shareholder must determine his or her level of participation, the corporation will not be able to identify significant participation passive activities.

2. Certain nondepreciable rental property activities.—Net passive income from a rental activity is nonpassive income if less than 30% of the unadjusted basis of the property used or held for use by customers in the activity is subject to depreciation under section 167.

3. Passive equity-financed lending activities.—If the corporation has net income from a passive equity-financed lending activity, the smaller of the net passive income or equity-financed interest income from the activity is nonpassive income.

Note: *The amount of income from the activities in items **1** through **3** above that any shareholder will be required to recharacterize as nonpassive income may be limited under Temporary Regulations section 1.469-2T(f)(8). Because the corporation will not have information regarding all of a shareholder's activities, it must identify all corporate activities meeting the definitions in items **2** and **3** as activities that may be subject to recharacterization.*

4. Rental activities incidental to a development activity.—Net rental activity income is nonpassive income for a shareholder if all of the following apply: **(a)** the corporation recognizes gain from the sale, exchange, or other disposition of the rental property during the tax year; **(b)** the use of the item of property in the rental activity started less than 12 months before the date of disposition (the use of an item of rental property begins on the first day on which (i) the corporation owns an interest in the property, (ii) substantially all of the property is either rented or held out for rent and ready to be rented, and (iii) no significant value-enhancing services remain to be performed); and **(c)** the shareholder materially participated or significantly participated for any tax year in an activity that involved the performance of services for the purpose of enhancing the value of the property (or any other item of property, if the basis of the property disposed of is determined in whole or in part by reference to the basis of that item of property). Net rental activity income is the excess of passive activity gross income from renting or disposing of property over passive activity deductions (current year deductions and prior year unallowed losses) that are reasonably allocable to the rented property.

Because the corporation cannot determine a shareholder's level of participation, the corporation must identify net income from property described in items **(a)** and **(b)** above as income that may be subject to recharacterization.

5. Activities involving property rented to a nonpassive activity.—If a taxpayer rents property to a trade or business activity in which the taxpayer materially participates, the taxpayer's net rental activity income (defined above) from the property is nonpassive income.

6. Acquisition of an interest in a pass-through entity that licenses intangible property.—Generally, net royalty income from intangible property is nonpassive income if the taxpayer acquired an interest in the pass-through entity after it created the intangible property or performed substantial services or incurred substantial costs in developing or marketing the intangible property. Net royalty income is the excess of passive activity gross income from licensing or transferring any right in intangible property over passive activity deductions (current year deductions and prior year unallowed losses) that are reasonably allocable to the intangible property.

See Temporary Regulations section 1.469-2T(f)(7)(iii) for exceptions to this rule.

Passive Activity Reporting Requirements

To allow shareholders to correctly apply the passive activity loss and credit limitation rules, any corporation that carries on more than one activity must:

1. Provide an attachment for each activity conducted through the corporation that identifies the type of activity conducted (trade or business, rental real estate, rental activity other than rental real estate, or investment).

2. On the attachment for each activity, provide a schedule, using the same line numbers as shown on Schedule K-1, detailing the net income (loss), credits, and all items required to be separately stated under section 1366(a)(1) from each trade or business activity, from each rental real estate activity, from each rental activity other than a rental real estate activity, and from investments.

3. Identify the net income (loss) and the shareholder's share of corporation interest expense from each activity of renting a dwelling unit that any shareholder uses for personal purposes during the year for more than the greater of 14 days or 10% of the number of days that the residence is rented at fair rental value.

4. Identify the net income (loss) and the shareholder's share of interest expense from each activity of trading personal property conducted through the corporation.

5. For any gain (loss) from the disposition of an interest in an activity or of an interest in property used in an activity (including dispositions before 1987 from which gain is being recognized after 1986):

a. Identify the activity in which the property was used at the time of disposition;

b. If the property was used in more than one activity during the 12 months preceding the disposition, identify the activities in which the property was used and the adjusted basis allocated to each activity; and

c. For gains only, if the property was substantially appreciated at the time of the disposition and the applicable holding period specified in Regulations section 1.469-2(c)(2)(iii)(A) was not satisfied, identify the amount of the nonpassive gain and indicate whether or not the gain is investment income under Regulations section 1.469-2(c)(2)(iii)(F).

6. Specify the amount of gross portfolio income, the interest expense properly allocable to portfolio income, and expenses other than interest expense that are clearly and directly allocable to portfolio income.

7. Identify the ratable portion of any section 481 adjustment (whether a net positive or a net negative adjustment) allocable to each corporate activity.

8. Identify any gross income from sources specifically excluded from passive activity gross income, including:

a. Income from intangible property, if the shareholder is an individual whose personal efforts significantly contributed to the creation of the property;

b. Income from state, local, or foreign income tax refunds; and

c. Income from a covenant not to compete, if the shareholder is an individual who contributed the covenant to the corporation.

9. Identify any deductions that are not passive activity deductions.

10. If the corporation makes a full or partial disposition of its interest in another entity, identify the gain (loss) allocable to each activity conducted through the entity, and the gain allocable to a passive activity that would have been recharacterized as nonpassive gain had the corporation disposed of its interest in property used in the activity (because the property was substantially appreciated at the time of the disposition, and the gain represented more than 10% of the shareholder's total gain from the disposition).

11. Identify the following items that may be subject to the recharacterization rules under Temporary Regulations section 1.469-2T(f) and Regulations section 1.469-2(f):

a. Net income from an activity of renting substantially nondepreciable property;

b. The smaller of equity-financed interest income or net passive income from an equity-financed lending activity;

c. Net rental activity income from property developed (by the shareholder or the corporation), rented, and sold within 12 months after the rental of the property commenced;

d. Net rental activity income from the rental of property by the corporation to a trade or business activity in which the shareholder had an interest (either directly or indirectly); and

e. Net royalty income from intangible property if the shareholder acquired the shareholder's interest in the corporation after the corporation created the intangible property or performed substantial services or incurred substantial costs in developing or marketing the intangible property.

12. Identify separately the credits from each activity conducted by or through the corporation.

Specific Instructions

General Information

Name, Address, and Employer Identification Number

Use the label on the postcard that was mailed to the corporation. Cross out any errors and print the correct information on the label.

Name.—If the corporation did not receive a label, print or type the corporation's true name (as set forth in the corporate charter or other legal document creating it).

Address.—Include the suite, room, or other unit number after the street address. If a preaddressed label is used, please include the information on the label. If the Post Office does not deliver to the street address and the corporation has a P.O. box, show the box number instead of the street address.

If the corporation changes its mailing address after filing its return, it can notify the IRS by filing **Form 8822,** Change of Address.

Employer identification number (EIN).— Show the correct EIN in Item C on page 1 of Form 1120S.

Item B—Business Code No.

See **Codes for Principal Business Activity** on page 24 of these instructions.

Item E—Total Assets

Enter the corporation's total assets at the end of the tax year, as determined by the accounting method regularly used in maintaining the corporation's books and records. If there were no assets at the end of the tax year, enter the total assets as of the beginning of the tax year.

Item F—Initial Return, Final Return, Change in Address, and Amended Return

If this is the corporation's first return, check box F(1). If the corporation has ceased to exist, check box F(2). Also check box D(1) on each Schedule K-1 to indicate that it is a final Schedule K-1. Indicate a change in address by checking box F(3). If this amends a previously filed return, check box F(4). If Schedules K-1 are also being amended, check box D(2) on each Schedule K-1.

Item G—Consolidated Audit Procedures

With certain exceptions, the tax treatment of S corporation items is determined at the corporate level in a consolidated audit proceeding, rather than in separate proceedings with individual shareholders. Check the box for item G if any of the following apply.

- The S corporation had more than five shareholders at any time during the tax year (for this purpose a husband and wife, and their estates, are treated as one shareholder).
- Any shareholder was other than a natural person or estate.
- The small S corporation (five or fewer shareholders) has elected as provided in Temporary Regulations section 301.6241-1T(c)(2)(v) to be subject to the rules for consolidated proceedings.

Note: *The S corporation does not make the section 301.6241-1T(c)(2)(v) election when it checks the box for item G. This election must be made separately.*

For more information on the consolidated audit procedures for S corporations, see sections 6241 through 6245, Temporary Regulations section 301.6241-1T, and **Pub. 556,** Examination of Returns, Appeal Rights, and Claims for Refund.

Income

Caution: *Report only trade or business activity income or loss on lines 1a through 6.* ***Do not report rental activity income or portfolio income or loss on these lines.*** *(See the instructions on* ***Passive Activity Limitations*** *beginning on page 5 for definitions of rental income and portfolio income.) Rental activity income and portfolio income are reported on Schedules K and K-1 (rental real estate activities are also reported on Form 8825).*

Do not include any tax-exempt income on lines 1 through 5. A corporation that receives any exempt income other than interest, or holds any property or engages in an activity that produces exempt income, reports the amount of this income on line 18 of Schedules K and K-1.

Report tax-exempt interest income, including exempt-interest dividends received as a shareholder in a mutual fund or other regulated investment company, on line 17 of Schedules K and K-1.

See **Deductions** on page 10 for information on how to report expenses related to tax-exempt income.

If the S corporation has had debt discharged resulting from a title 11 bankruptcy proceeding, or while insolvent, see **Form 982,** Reduction of Tax Attributes Due to Discharge of Indebtedness, and **Pub. 908,** Tax Information on Bankruptcy.

Line 1—Gross Receipts or Sales

Enter gross receipts or sales from all trade or business operations except those you report on lines 4 and 5. For reporting advance payments, see Regulations section 1.451-5. To report income from long-term contracts, see section 460.

Installment sales.—Generally, the installment method cannot be used for dealer dispositions of property. A dealer disposition is any disposition of personal property by a person who regularly sells or otherwise disposes of property of the same type on the installment plan or any disposition of real property held for sale to customers in the ordinary course of the taxpayer's trade or business. The disposition of property used or produced in the farming business is not included as a dealer disposition. See section 453(l) for details and exceptions.

Enter on line 1a the gross profit on collections from installment sales for any of the following:

- Dealer dispositions of property before March 1, 1986.
- Dispositions of property used or produced in the trade or business of farming.
- Certain dispositions of timeshares and residential lots reported under the installment method.

Attach a schedule showing the following information for the current and the 3 preceding years: **(a)** gross sales, **(b)** cost of goods sold, **(c)** gross profits, **(d)** percentage of gross profits to gross sales, **(e)** amount collected, and **(f)** gross profit on the amount collected.

Line 2—Cost of Goods Sold

See the instructions for Schedule A.

Line 4—Net Gain (Loss) From Form 4797

Caution: *Include only ordinary gains or losses from the sale, exchange, or involuntary conversion of assets used in a trade or business activity. Ordinary gains or losses from the sale, exchange, or involuntary conversions of assets used in rental activities are reported separately on Schedule K as part of the net income (loss) from the rental activity in which the property was used.*

A corporation that is a partner in a partnership must include on **Form 4797,** Sales of Business Property, its share of ordinary gains (losses) from sales, exchanges, or involuntary or compulsory conversions (other than casualties or thefts) of the partnership's trade or business assets.

Do not include any recapture of the section 179 expense deduction. See the instructions on page 21 for Schedule K-1, line 23, item 3, and the Instructions for Form 4797 for more information.

Line 5—Other Income (Loss)

Enter on line 5 trade or business income (loss) that is not included on lines 1a

through 4. Examples of such income include:

1. Interest income derived in the ordinary course of the corporation's trade or business, such as interest charged on receivable balances;

2. Recoveries of bad debts deducted in earlier years under the specific charge-off method;

3. Taxable income from insurance proceeds;

4. The amount of credit figured on **Form 6478,** Credit for Alcohol Used as Fuel;

5. All section 481 income adjustments resulting from changes in accounting methods (show the computation on an attached schedule); and

6. Ordinary income (loss) from trade or business activities of a partnership (from Schedule K-1 (Form 1065), line 1).

The corporation must include as other income the recapture amount for section 280F if the business use of listed property drops to 50% or less. To figure the recapture amount, the corporation must complete Part IV of Form 4797.

The corporation must also include in other income the amount of any deduction previously taken under section 179A that is subject to recapture. The S corporation must recapture the benefit of any allowable deduction for qualified clean-fuel vehicle property (or clean-fuel vehicle refueling property), if, within 3 years after the date the property was placed in service, the property ceases to qualify for the deduction. See Pub. 535 for details on how to figure the recapture.

Do not include items requiring separate computations by shareholders that must be reported on Schedules K and K-1. See the instructions for Schedules K and K-1 beginning on page 15.

If "other income" consists of only one item, identify it by showing the account caption in parentheses on line 5. A separate schedule need not be attached to the return in this case.

Do not net any expense item (such as interest) with a similar income item. Report all trade or business expenses on lines 7 through 19.

Deductions

Caution: *Report **only** trade or business activity expenses on lines 7 through 19.*

Do not report rental activity expenses or deductions allocable to portfolio income on these lines. Rental activity expenses are separately reported on Form 8825 or line 3 of Schedules K and K-1. Deductions allocable to portfolio income are separately reported on line 9 of Schedules K and K-1. See **Passive Activity Limitations** beginning on page 5 for more information on rental activities and portfolio income.

Do not report any nondeductible amounts (such as expenses connected with the production of tax-exempt income) on lines 7 through 19. Instead, report nondeductible expenses on line 19 of Schedules K and K-1. If an expense is connected with both taxable income and nontaxable income, allocate a reasonable part of the expense to each kind of income.

Limitations on Deductions

Section 263A uniform capitalization rules.—The uniform capitalization rules of section 263A require corporations to capitalize or include in inventory certain costs incurred in connection with the production of real and personal tangible property held in inventory or held for sale in the ordinary course of business. Tangible personal property produced by a corporation includes a film, sound recording, video tape, book, or similar property. The rules also apply to personal property (tangible and intangible) acquired for resale. Corporations subject to the rules are required to capitalize not only direct costs but an allocable portion of most indirect costs (including taxes) that benefit the assets produced or acquired for resale. Interest expense paid or incurred during the production period of certain property must be capitalized and is governed by special rules. For more information, see Regulations sections 1.263A-8 through 1.263A-15. The uniform capitalization rules also apply to the production of property constructed or improved by a corporation for use in its trade or business or in an activity engaged in for profit.

Section 263A does not apply to personal property acquired for resale if the taxpayer's average annual gross receipts for the 3 prior tax years are $10 million or less. It does not apply to timber or to most property produced under a long-term contract. Special rules apply to certain corporations engaged in farming (see below). The rules do not apply to property produced for use by the taxpayer if substantial construction occurred before March 1, 1986.

In the case of inventory, some of the indirect costs that must be capitalized are administration expenses; taxes; depreciation; insurance; compensation paid to officers attributable to services; rework labor; and contributions to pension, stock bonus, and certain profit-sharing, annuity, or deferred compensation plans.

The costs required to be capitalized under section 263A are not deductible until the property to which the costs relate is sold, used, or otherwise disposed of by the corporation.

Research and experimental costs under section 174; intangible drilling costs for oil, gas, and geothermal property; and mining exploration and development costs are separately reported to shareholders for purposes of determinations under section 59(e). Regulations section 1.263A-1(e)(3) specifies other indirect costs that may be currently deducted and those that must be capitalized with respect to production or resale activities.

For more information, see Regulations sections 1.263A-1 through 1.263A-3.

Special rules for certain corporations engaged in farming.—For S corporations not required to use the accrual method of accounting, the rules of section 263A do **not** apply to expenses of raising any **(a)** animal or **(b)** plant that has a preproductive period of 2 years or less. Shareholders of S corporations not required to use the accrual method of accounting may elect to currently deduct the preproductive period expenses of certain plants that have a preproductive period of more than 2 years. Because the election to deduct these expenses is made by the shareholder, the farming corporation should not capitalize such preproductive expenses but should separately report these expenses on line 21 of Schedule K, and each shareholder's share on line 23 of Schedule K-1. See sections 263A(d) and (e) and Temporary Regulations section 1.263A-4T(c) for definitions and other details. Also see Notice 88-24, 1988-1 C.B. 491, and section II(C) of Notice 89-67, 1989-1 C.B. 723.

Transactions between related taxpayers.—Generally, an accrual basis S corporation may deduct business expenses and interest owed to a related party (including any shareholder) **only** in the tax year of the corporation that includes the day on which the payment is includible in the income of the related party. See section 267 for details.

Section 291 limitations.—If the S corporation was a C corporation for any of the 3 immediately preceding years, the corporation may be required to adjust deductions allowed to the corporation for depletion of iron ore and coal, and the amortizable basis of pollution control facilities. See section 291 to determine the amount of the adjustment.

Business start-up expenses.—Business start-up expenses must be capitalized. An election may be made to amortize them over a period of not less than 60 months. See section 195.

Reducing certain expenses for which credits are allowable.—For each of the credits listed below, the corporation must reduce the otherwise allowable deductions for expenses used to figure the credit by the amount of the current year credit:

1. The credit for increasing research activities,

2. The enhanced oil recovery credit,

3. The disabled access credit,

4. The jobs credit,

5. The empowerment zone employment credit,

6. The Indian employment credit, and

7. The credit for employer social security and Medicare taxes paid on certain employee tips.

If the corporation has any of these credits, be sure to figure each current year credit before figuring the deductions for expenses on which the credit is based.

Line 7—Compensation of Officers

Enter on line 7 the total compensation of all officers paid or incurred in the trade or business activities of the corporation, including fringe benefit expenditures made on behalf of officers owning more than 2%

of the corporation's stock. Also report these fringe benefits as wages in box 1 of Form W-2. Do not include on line 7 amounts paid or incurred for fringe benefits of officers owning 2% or less of the corporation's stock. These amounts are reported on line 18, page 1, of Form 1120S. See the instructions for that line for information on the types of expenditures that are treated as fringe benefits and for the stock ownership rules.

Report amounts paid for health insurance coverage for a more than 2% shareholder (including that shareholder's spouse and dependents) as an information item in box 14 of that shareholder's Form W-2. A more than 2% shareholder may be allowed to deduct up to 30% of such amounts on Form 1040, line 26.

Do not include on line 7 compensation reported elsewhere on the return, such as amounts included in cost of goods sold, elective contributions to a section 401(k) cash or deferred arrangement, or amounts contributed under a salary reduction SEP agreement.

Line 8—Salaries and Wages

Enter on line 8 the amount of salaries and wages paid or incurred for the tax year, reduced by any applicable employment credits from **Form 5884,** Jobs Credit, **Form 8844,** Empowerment Zone Employment Credit, and **Form 8845,** Indian Employment Credit. See the instructions for these forms for more information. Include fringe benefit expenditures made on behalf of employees (other than officers) owning more than 2% of the corporation's stock. Also report these fringe benefits as wages in box 1 of Form W-2. Do not include on line 8 amounts paid or incurred for fringe benefits of employees owning 2% or less of the corporation's stock. These amounts are reported on line 18, page 1, of Form 1120S. See the instructions for that line for information on the types of expenditures that are treated as fringe benefits and for the stock ownership rules.

Report amounts paid for health insurance coverage for a more than 2% shareholder (including that shareholder's spouse and dependents) as an information item in box 14 of that shareholder's Form W-2. A more than 2% shareholder may be allowed to deduct up to 30% of such amounts on Form 1040, line 26.

Do not include on line 8 salaries and wages reported elsewhere on the return, such as amounts included in cost of goods sold, elective contributions to a section 401(k) cash or deferred arrangement, or amounts contributed under a salary reduction SEP agreement.

If a shareholder or a member of the family of one or more shareholders of the corporation renders services or furnishes capital to the corporation for which reasonable compensation is not paid, the IRS may make adjustments in the items taken into account by such individuals and the value of such services or capital. See section 1366(e).

Line 9—Repairs and Maintenance

Enter the costs of incidental repairs and maintenance, such as labor and supplies, that do not add to the value of the property or appreciably prolong its life, but only to the extent that such costs relate to a trade or business activity and are not claimed elsewhere on the return. New buildings, machinery, or permanent improvements that increase the value of the property are not deductible. They are chargeable to capital accounts and may be depreciated or amortized.

Line 10—Bad Debts

Enter the total debts that became worthless in whole or in part during the year, but only to the extent such debts relate to a trade or business activity. Report deductible nonbusiness bad debts as a short-term capital loss on Schedule D (Form 1120S).

Caution: *Cash method taxpayers cannot take a bad debt deduction unless the amount was previously included in income.*

Line 11—Rents

If the corporation rented or leased a vehicle, enter the total annual rent or lease expense paid or incurred in the trade or business activities of the corporation. Also complete Part V of **Form 4562,** Depreciation and Amortization. If the corporation leased a vehicle for a term of 30 days or more, the deduction for vehicle lease expense may have to be reduced by an amount called the **inclusion amount.** The corporation may have an inclusion amount if—

The lease term began:	And the vehicle's fair market value on the first day of the lease exceeded:
After 12/31/94	$15,500
After 12/31/93 but before 1/1/95	$14,600
After 12/31/92 but before 1/1/94	$14,300
After 12/31/91 but before 1/1/93	$13,700
After 12/31/90 but before 1/1/92	$13,400
After 12/31/86 but before 1/1/91	$12,800

If the lease term began after June 18, 1984, but before January 1, 1987, get **Pub. 917,** Business Use of a Car, to find out if the corporation has an inclusion amount.

See Pub. 917 for instructions on figuring the inclusion amount.

Line 12—Taxes and Licenses

Enter taxes and licenses paid or incurred in the trade or business activities of the corporation, if not reflected in cost of goods sold. Federal import duties and Federal excise and stamp taxes are deductible only if paid or incurred in carrying on the trade or business of the corporation.

Do not deduct taxes, including state and local sales taxes, paid or accrued in connection with the acquisition or disposition of business property. These taxes must be added to the cost of the property, or in the case of a disposition, subtracted from the amount realized. See section 164.

Do not deduct taxes assessed against local benefits that increase the value of the property assessed (such as for paving, etc.), Federal income taxes, or taxes reported elsewhere on the return.

Do not deduct section 901 foreign taxes. These taxes are reported separately on line 15e, Schedule K.

Do not report on line 12 taxes allocable to portfolio income or to a rental activity. Taxes allocable to a rental real estate activity are reported on Form 8825. Taxes allocable to a rental activity other than a rental real estate activity are reported on line 3b of Schedule K. Taxes allocable to portfolio income are reported on line 9 of Schedules K and K-1.

Do not deduct on line 12 taxes paid or incurred for the production or collection of income, or for the management, conservation, or maintenance of property held to produce income. Report these taxes separately on line 10 of Schedules K and K-1.

See section 263A(a) for information on capitalization of allocable costs (including taxes) for any property.

Line 13—Interest

Include on line 13 only interest incurred in the trade or business activities of the corporation that is not claimed elsewhere on the return.

Do not include interest expense on debt used to purchase rental property or debt used in a rental activity. Interest allocable to a rental real estate activity is reported on Form 8825 and is used in arriving at net income (loss) from rental real estate activities on line 2 of Schedules K and K-1. Interest allocable to a rental activity other than a rental real estate activity is included on line 3b of Schedule K and is used in arriving at net income (loss) from a rental activity (other than a rental real estate activity). This net amount is reported on line 3c of Schedule K and line 3 of Schedule K-1.

Do not include interest expense clearly and directly allocable to portfolio or investment income. This interest expense is reported separately on line 11a of Schedule K.

Do not include interest on debt proceeds allocated to distributions made to shareholders during the tax year. Instead, report such interest on line 10 of Schedules K and K-1. To determine the amount to allocate to distributions to shareholders, see Notice 89-35, 1989-1 C.B. 675.

Do not include interest expense on debt required to be allocated to the production of qualified property. Interest allocable to certain property produced by an S corporation for its own use or for sale must be capitalized. The corporation must also capitalize any interest on debt that is allocable to an asset used to produce the above property. A shareholder may have to capitalize interest that the shareholder incurs during the tax year for the production expenditures of the S corporation. Similarly, interest incurred by

an S corporation may have to be capitalized by a shareholder for the shareholder's own production expenditures. The information required by the shareholder to properly capitalize interest for this purpose must be provided by the corporation in an attachment for line 23 of Schedule K-1 (see the instructions on page 22 for Schedule K-1, line 23, item 9). See section 263A(f) and Regulations sections 1.263A-8 through 1.263A-15 for additional information.

Temporary Regulations section 1.163-8T gives rules for allocating interest expense among activities so that the limitations on passive activity losses, investment interest, and personal interest can be properly figured. Generally, interest expense is allocated in the same manner as debt is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. These regulations give rules for tracing debt proceeds to expenditures.

Generally, prepaid interest can only be deducted over the period to which the prepayment applies. See section 461(g) for details.

Line 14—Depreciation

Enter on line 14a only the depreciation claimed on assets used in a trade or business activity. See the Instructions for Form 4562 or **Pub. 946,** How To Depreciate Property, to figure the amount of depreciation to enter on this line. Complete and attach Form 4562 only if the corporation placed property in service during 1995 or claims depreciation on any car or other listed property.

Do not include any section 179 expense deduction on this line. This amount is not deductible by the corporation. Instead, it is passed through to the shareholders on line 8 of Schedule K-1.

Line 15—Depletion

If the corporation claims a deduction for timber depletion, complete and attach **Form T,** Forest Activities Schedules.

Caution: *Do not deduct depletion for oil and gas properties. Each shareholder figures depletion on these properties under section 613A(c)(11). See the instructions on page 21 for Schedule K-1, line 23, item 2, for information on oil and gas depletion that must be supplied to the shareholders by the corporation.*

Line 17—Pension, Profit-Sharing, etc., Plans

Enter the deductible contributions not claimed elsewhere on the return made by the corporation for its employees under a qualified pension, profit-sharing, annuity, or simplified employee pension (SEP) plan, and under any other deferred compensation plan.

If the corporation contributes to an individual retirement arrangement (IRA) for employees, include the contribution in salaries and wages on page 1, line 8, or Schedule A, line 3, and not on line 17.

Employers who maintain a pension, profit-sharing, or other funded deferred compensation plan, whether or not qualified under the Internal Revenue Code and whether or not a deduction is claimed for the current tax year, generally must file one of the forms listed below:

Form 5500, Annual Return/Report of Employee Benefit Plan (With 100 or more participants).

Form 5500-C/R, Return/Report of Employee Benefit Plan (With fewer than 100 participants).

Form 5500-EZ, Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan.

There are penalties for failure to file these forms on time and for overstating the pension plan deduction.

Line 18—Employee Benefit Programs

Enter amounts for fringe benefits paid or incurred on behalf of employees owning 2% or less of the corporation's stock. These fringe benefits include **(a)** up to $5,000 paid by reason of an employee's death to his estate or beneficiary, **(b)** employer contributions to certain accident and health plans, **(c)** the cost of up to $50,000 of group-term life insurance on an employee's life, and **(d)** meals and lodging furnished for the employer's convenience.

Do not deduct amounts that are an incidental part of a pension, profit-sharing, etc., plan included on line 17 or amounts reported elsewhere on the return.

Report amounts paid on behalf of more than 2% shareholders on line 7 or 8, whichever applies. A shareholder is considered to own more than 2% of the corporation's stock if that person owns on any day during the tax year more than 2% of the outstanding stock of the corporation or stock possessing more than 2% of the combined voting power of all stock of the corporation. See section 318 for attribution rules.

Line 19—Other Deductions

Attach your own schedule listing by type and amount all allowable deductions related to a trade or business activity for which there is no separate line on page 1 of Form 1120S. Enter the total on this line. Do not include items that must be reported separately on Schedules K and K-1.

An S corporation may not take the deduction for net operating losses provided by section 172 or the special deductions in sections 241 through 249 (except the election to amortize organizational expenditures under section 248). Subject to limitations, the corporation's net operating loss is allowed as a deduction from the shareholders' gross income. See section 1366.

Do not include qualified expenditures to which an election under section 59(e) may apply. See the instructions on page 21 for lines 16a and 16b of Schedule K-1 for details on treatment of these items.

Include on line 19 the deduction taken for amortization. See the instructions for Form 4562 for more information. Complete and attach Form 4562 if the corporation is claiming amortization of costs that began during its 1995 tax year.

Section 464(f) limits the deduction for certain expenditures of S corporations engaged in farming that use the cash method of accounting, and whose prepaid farm supplies are more than 50% of other deductible farming expenses. Prepaid farm supplies include expenses for feed, seed, fertilizer, and similar farm supplies not used or consumed during the year. They also include the cost of poultry that would be allowable as a deduction in a later tax year if the corporation were to **(a)** capitalize the cost of poultry bought for use in its farm business and deduct it ratably over the lesser of 12 months or the useful life of the poultry, and **(b)** deduct the cost of poultry bought for resale in the year it sells or otherwise disposes of it. If the limit applies, the corporation can deduct prepaid farm supplies that do not exceed 50% of its other deductible farm expenses in the year of payment. The excess is deductible only in the year the corporation uses or consumes the supplies (other than poultry, which is deductible as explained above). For exceptions and more details on these rules, get **Pub. 225,** Farmer's Tax Guide.

Do not deduct amounts paid or incurred to participate or intervene in any political campaign on behalf of a candidate for public office, or to influence the general public regarding legislative matters, elections, or referendums. In addition, corporations generally cannot deduct expenses paid or incurred to influence Federal or state legislation, or to influence the actions or positions of certain Federal executive branch officials. However, certain in-house lobbying expenditures that do not exceed $2,000 are deductible. See section 162(e) for more details.

Do not deduct fines or penalties paid to a government for violating any law.

A deduction is allowed for part of the cost of qualified clean-fuel vehicle property and qualified clean-fuel vehicle refueling property. For more details, see section 179A.

Meals, travel, and entertainment.— Generally, the corporation can deduct only 50% of the amount otherwise allowable for meals and entertainment expenses paid or incurred in its trade or business. In addition, meals must not be lavish or extravagant; a bona fide business discussion must occur during, immediately before, or immediately after the meal; and an employee of the corporation must be present at the meal. See section 274(k)(2) for exceptions.

Additional limitations apply to deductions for gifts, skybox rentals, luxury water travel, convention expenses, and entertainment tickets. See section 274 and **Pub. 463,** Travel, Entertainment, and Gift Expenses, for details.

Corporations are not allowed to deduct amounts paid or incurred for membership

dues in any club organized for business, pleasure, recreation, or other social purpose. This includes country clubs, golf and athletic clubs, airline and hotel clubs, and clubs operated to provide meals under conditions favorable to business discussion. But it does not include civic or public service organizations, professional organizations (such as bar and medical associations), business leagues, trade associations, chambers of commerce, boards of trade, and real estate boards, unless a principal purpose of the organization is to entertain, or provide entertainment facilities for, members or their guests.

In addition, no deduction is allowed for travel expenses paid or incurred for an officer's or employee's spouse or dependent or other individual accompanying an officer or employee of the corporation, unless that spouse, dependent, or other individual is an employee of the corporation, and that person's travel is for a bona fide business purpose and would otherwise be deductible by that person.

Generally, a corporation can deduct all other ordinary and necessary travel and entertainment expenses paid or incurred in its trade or business. However, it cannot deduct an expense paid or incurred for a facility (such as a yacht or hunting lodge) used for an activity usually considered entertainment, amusement, or recreation.

Note: *The corporation may be able to deduct otherwise nondeductible meals, travel, and entertainment expenses if the amounts are treated as compensation and reported on Form W-2 for an employee or on Form 1099-MISC for an independent contractor.*

See Pub. 463 for more details.

Line 21—Ordinary Income (Loss)

Enter this income or loss on line 1 of Schedule K. Line 21 income is not used in figuring the tax on line 22a or 22b. See the instructions for line 22a for figuring taxable income for purposes of line 22a or 22b tax.

Tax and Payments

Line 22a—Excess Net Passive Income Tax

If the corporation has always been an S corporation, the excess net passive income tax does not apply. If the corporation has subchapter C earnings and profits (defined in section 1362(d)(3)(B)) at the close of its tax year, has passive investment income for the tax year that is in excess of 25% of gross receipts, **and** has taxable income at year end, the corporation must pay a tax on the excess net passive income. Complete lines 1 through 3 and line 9 of the worksheet below to make this determination. If line 2 is greater than line 3 and the corporation has taxable income (see instructions for line 9 of worksheet), it must pay the tax. Complete a separate schedule using the format of lines 1 through 11 of the worksheet below to figure the tax. Enter the tax on line 22a, page 1, Form 1120S, and attach the computation schedule to Form 1120S.

Reduce each item of passive income passed through to shareholders by its portion of tax on line 22a. See section 1366(f)(3).

Line 22b—Tax From Schedule D (Form 1120S)

If the corporation elected to be an S corporation before 1987 (or elected to be an S corporation during 1987 or 1988 and qualifies for transitional relief from the built-in gains tax), see instructions for Part III of Schedule D (Form 1120S) to determine if the corporation is liable for the capital gains tax.

If the corporation made its election to be an S corporation after 1986, see the instructions for Part IV of Schedule D to determine if the corporation is liable for the built-in gains tax.

Note: *For purposes of line 19 of Part III and line 25 of Part IV of Schedule D, taxable income is defined in section 1375(b)(1)(B) and is generally figured in the same manner as taxable income for line 9 of the line 22a worksheet below.*

Line 22c

Include in the total for line 22c the following:

Investment credit recapture tax.— The corporation is liable for investment credit recapture attributable to credits allowed for tax years for which the corporation was not an S corporation. Figure the corporation's investment credit recapture tax by completing **Form 4255,** Recapture of Investment Credit. Include the tax in the total amount to be entered on line 22c. Write to the left of the line 22c total the amount of recapture tax and the words "Tax From Form 4255," and attach Form 4255 to Form 1120S.

LIFO recapture tax.—The corporation may be liable for the additional tax due to LIFO recapture under Regulations section 1.1363-2 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 after August 18, 1993, to the corporation in a nonrecognition transaction in which those assets were transferred basis property.

The additional tax due to LIFO recapture is figured for the corporation's last tax year as a C corporation or for the tax year of the transfer, whichever applies. See the Instructions for Forms 1120 and 1120-A to figure the tax. 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 for the corporation's last tax year as a C corporation or for the tax year of the transfer, whichever applies. The S corporation must pay each of the remaining installments by the due date (not including extensions) of Form 1120S for the 3 succeeding tax years. Include this year's installment in the total amount to be entered on line 22c. Write to the left of the total on line 22c the installment amount and the words "LIFO tax."

Interest due under the look-back method for completed long-term contracts.—If the corporation completed **Form 8697,** Interest Computation Under the Look-Back Method for Completed Long-Term Contracts, and owes interest,

Worksheet for Line 22a

1. Enter gross receipts for the tax year (see section 1362(d)(3)(C) for gross receipts from the sale of capital assets)* . . . . . _____
2. Enter passive investment income as defined in Regulations section 1.1362-2(c)(5)* . . . . . _____
3. Enter 25% of line 1 (If line 2 is less than line 3, stop here. You are not liable for this tax.) . . . . . _____
4. Excess passive investment income—Subtract line 3 from line 2 . . . _____
5. Enter deductions directly connected with the production of income on line 2 (see section 1375(b)(2))* . . . _____
6. Net passive income—Subtract line 5 from line 2 . . . . . _____
7. Divide amount on line 4 by amount on line 2 . . . . . _____ %
8. Excess net passive income—Multiply line 6 by line 7 . . . . . _____
9. Enter taxable income (see instructions for taxable income below) . . . _____
10. Enter smaller of line 8 or line 9 . . _____
11. Excess net passive income tax—Enter 35% of line 10. Enter here and on line 22a, page 1, Form 1120S . . . _____

*Income and deductions on lines 1, 2, and 5 are from total operations for the tax year. This includes applicable income and expenses from page 1, Form 1120S, as well as those reported separately on Schedule K. See section 1375(b)(4) for an exception regarding lines 2 and 5.

Line 9 of Worksheet—Taxable income

Line 9 taxable income is defined in Regulations section 1.1374-1(d). Figure this income by completing lines 1 through 28 of **Form 1120,** U.S. Corporation Income Tax Return. Include the Form 1120 computation with the worksheet computation you attach to Form 1120S. You do not have to attach the schedules, etc., called for on Form 1120. However, you may want to complete certain Form 1120 schedules, such as Schedule D (Form 1120) if you have capital gains or losses.

write to the left of the line 22c total the amount of interest and "From Form 8697." Attach the completed form to Form 1120S.

Line 23d

If the S corporation is a beneficiary of a trust and the trust makes a section 643(g) election to credit its estimated tax payments to its beneficiaries, include the corporation's share of the payment (reported to the corporation on Schedule K-1 (Form 1041)) in the total amount entered on line 23d. Also, to the left of line 23d, write "T" and the amount of the payment.

Line 24—Estimated Tax Penalty

A corporation that fails to make estimated tax payments when due may be subject to an underpayment penalty for the period of underpayment. Use **Form 2220,** Underpayment of Estimated Tax by Corporations, to see if the corporation owes a penalty and to figure the amount of the penalty. If you attach Form 2220 to Form 1120S, be sure to check the box on line 24 and enter the amount of any penalty on this line.

Schedule A—Cost of Goods Sold

Inventories are required at the beginning and end of each tax year if the production, purchase, or sale of merchandise is an income-producing factor. See Regulations section 1.471-1.

Section 263A Uniform Capitalization Rules

The uniform capitalization rules of section 263A are discussed under **Limitations on Deductions** on page 10. See those instructions before completing Schedule A.

Line 4—Additional Section 263A Costs

An entry is required on this line only for corporations that have elected a simplified method of accounting.

For corporations that have elected the simplified production method, additional section 263A costs are generally those costs, other than interest, that were not capitalized under the corporation's method of accounting immediately prior to the effective date of section 263A that are required to be capitalized under section 263A. For new corporations, additional section 263A costs are the costs, other than interest, that must be capitalized under section 263A, but which the corporation would not have been required to capitalize if it had existed before the effective date of section 263A. For more details, see Regulations section 1.263A-2(b).

For corporations that have elected the simplified resale method, additional section 263A costs are generally those costs incurred with respect to the following categories: off-site storage or warehousing; purchasing; handling, processing, assembly, and repackaging; and general and administrative costs (mixed service costs). For more details, see Regulations section 1.263A-3(d).

Enter on line 4 the balance of section 263A costs paid or incurred during the tax year not included on lines 2, 3, and 5.

Line 5—Other Costs

Enter on line 5 any other inventoriable costs paid or incurred during the tax year not entered on lines 2 through 4.

Line 7—Inventory at End of Year

See Regulations sections 1.263A-1 through 1.263A-3 for details on figuring the costs to be included in ending inventory.

Lines 9a through 9e—Inventory Valuation Methods

Inventories can be valued at **(a)** cost, **(b)** cost or market value (whichever is lower), or **(c)** any other method approved by the IRS that conforms to the requirements of the applicable regulations.

The average cost (rolling average) method of valuing inventories generally does not conform to the requirements of the regulations. See Rev. Rul. 71-234, 1971-1 C.B. 148.

Corporations that use erroneous valuation methods must change to a method permitted for Federal income tax purposes. To make this change, use Form 3115.

On line 9a, check the method(s) used for valuing inventories. Under "lower of cost or market," *market* (for normal goods) means the current bid price prevailing on the inventory valuation date for the particular merchandise in the volume usually purchased by the taxpayer. For a manufacturer, market applies to the basic elements of cost—raw materials, labor and burden. If section 263A applies to the taxpayer, the basic elements of cost must reflect the current bid price of all direct costs and all indirect costs properly allocable to goods on hand at the inventory date.

Inventory may be valued below cost when the merchandise is unsalable at normal prices or unusable in the normal way because the goods are "subnormal" due to damage, imperfections, shop wear, etc., within the meaning of Regulations section 1.471-2(c). These goods may be valued at a current bona fide selling price minus direct cost of disposition (but not less than scrap value) if such a price can be established.

If this is the first year the last-in, first-out (LIFO) inventory method was either adopted or extended to inventory goods not previously valued under the LIFO method provided in section 472, attach **Form 970,** Application To Use LIFO Inventory Method, or a statement with the information required by Form 970. Also check the LIFO box on line 9c. On line 9d, enter the amount or the percent of total closing inventories covered under section 472. Estimates are acceptable.

If the corporation has changed or extended its inventory method to LIFO and has had to "write up" its opening inventory to cost in the year of election, report the effect of this write-up as income (line 5, page 1) proportionately over a 3-year period that begins with the tax year of the election (section 472(d)).

See Pub. 538 for more information on inventory valuation methods.

Schedule B—Other Information

Be sure to answer the questions and provide other information in items 1 through 10.

Line 5—Foreign Financial Accounts

Answer "Yes" to question 5 if either **1** or **2** below applies to the corporation. Otherwise, check the "No" box.

1. At any time during calendar year 1995, the corporation had an interest in or signature or other authority over a bank account, securities account, or other financial account in a foreign country; AND

- The combined value of the accounts was more than $10,000 during the calendar year; AND
- The accounts were NOT with a U.S. military banking facility operated by a U.S. financial institution.

2. The corporation owns more than 50% of the stock in any corporation that would answer the question "Yes" based on item **1** above.

Get **Form TD F 90-22.1,** Report of Foreign Bank and Financial Accounts, to see if the corporation is considered to have an interest in or signature or other authority over a bank account, securities account, or other financial account in a foreign country.

If you answered "Yes" to question 5, file Form TD F 90-22.1 by June 30, 1996, with the Department of the Treasury at the address shown on the form. Form TD F 90-22.1 is not a tax return, so do not file it with Form 1120S. Form TD F 90-22.1 may be ordered by calling 1-800-TAX-FORM (1-800-829-3676).

Line 9

Complete line 9 if the corporation **(a)** filed its election to be an S corporation after 1986; **(b)** was a C corporation before it elected to be an S corporation **or** the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation; and **(c)** has net unrealized built-in gain (defined below) in excess of the net recognized built-in gain from prior years.

The corporation is liable for section 1374 tax if **(a), (b),** and **(c)** above apply and it has a net recognized built-in gain (section 1374(d)(2)) for its tax year.

Section 633(d)(8) of the Tax Reform Act of 1986 provides transitional relief from the built-in gains tax for certain corporations that elected to be S corporations in 1987 or 1988. See the instructions for Part IV of

Schedule D (Form 1120S) for more information.

The corporation's net unrealized built-in gain is the amount, if any, by which the fair market value of the assets of the corporation at the beginning of its first S corporation year (or as of the date the assets were acquired, for any asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation) exceeds the aggregate adjusted basis of such assets at that time.

Enter on line 9 the corporation's net unrealized built-in gain reduced by the net recognized built-in gain for prior years. See sections 1374(c)(2) and (d)(1).

Line 10

Check the box on line 10 if the corporation was a C corporation in a prior year and has subchapter C earnings and profits (E&P) at the close of its 1995 tax year. For this purpose, subchapter C E&P is E&P of any corporation for any tax year when it was not an S corporation. See sections 1362(d)(3)(B) and 312 for other details. If the corporation has subchapter C E&P, it may be liable for tax imposed on excess net passive income. See the instructions for line 22a, page 1, of Form 1120S for details on this tax.

Designation of Tax Matters Person (TMP)

If the S corporation is subject to sections 6241 through 6245 (consolidated audit procedures), it may designate a shareholder as the TMP for the tax year for which the return is filed by completing the **Designation of Tax Matters Person** section at the bottom of page 2 of Form 1120S. Temporary Regulations section 301.6241-1T provides an exception to the consolidated provisions for small S corporations with five or fewer shareholders each of whom is a natural person or an estate. See the instructions for item G on page 9 for other details.

General Instructions for Schedules K and K-1—Shareholders' Shares of Income, Credits, Deductions, etc.

Purpose of Schedules

The corporation is liable for taxes on lines 22a, b, and c, page 1, Form 1120S. Shareholders are liable for income tax on their shares of the corporation's income (reduced by any taxes paid by the corporation on income) and must include their share of the income on their tax return whether or not it is distributed to them. Unlike most partnership income, S corporation income is **not** self-employment income and is not subject to self-employment tax.

Schedule K is a summary schedule of all the shareholders' shares of the corporation's income, deductions, credits, etc. Schedule K-1 shows each shareholder's separate share. Attach a copy of each shareholder's Schedule K-1 to the Form 1120S filed with the IRS. Keep a copy as a part of the corporation's records, and give each shareholder a separate copy.

The total pro rata share items (column (b)) of all Schedules K-1 should equal the amount reported on the same line of Schedule K. Lines 1 through 20 of Schedule K correspond to lines 1 through 20 of Schedule K-1. Other lines do not correspond, but instructions explain the differences.

Be sure to give each shareholder a copy of the Shareholder's Instructions for Schedule K-1 (Form 1120S). These instructions are available separately from Schedule K-1 at most IRS offices.

Note: *Instructions that apply only to line items reported on Schedule K-1 may be prepared and given to each shareholder instead of the instructions printed by the IRS.*

Substitute Forms

The corporation **does not** need IRS approval to use a substitute Schedule K-1 if it is an exact copy of the IRS schedule, **or** if it contains only those lines the taxpayer is required to use, and the lines have the same numbers and titles and are in the same order as on the IRS Schedule K-1. In either case, the substitute schedule must include the OMB number and either **(a)** the Shareholder's Instructions for Schedule K-1 (Form 1120S) or **(b)** instructions that apply to the items reported on Schedule K-1 (Form 1120S).

The corporation must request IRS approval to use other substitute Schedules K-1. To request approval, write to Internal Revenue Service, Attention: Substitute Forms Program Coordinator, T:FP:S, 1111 Constitution Avenue, N.W., Washington, DC 20224.

The corporation may be subject to a penalty if it files a substitute Schedule K-1 that does not conform to the specifications of Rev. Proc. 94-34, 1994-1 C.B. 628.

Shareholder's Pro Rata Share Items

General Rule

Items of income, loss, deductions, etc., are allocated to a shareholder on a daily basis, according to the number of shares of stock held by the shareholder on each day during the tax year of the corporation. See the instructions for item A on page 16.

A transferee shareholder (rather than the transferor) is considered to be the owner of stock on the day it is transferred.

Special Rules

Termination of shareholder's interest.—If a shareholder terminates his or her interest in a corporation during the tax year, the corporation, with the consent of all shareholders (including the one whose interest is terminated), may elect to allocate income and expenses, etc., as if the corporation's tax year consisted of 2 tax years, the first of which ends on the date of the shareholder's termination. To make the election, the corporation must attach a statement to Form 1120S for the tax year for which the election is made. In the statement, the corporation must state that it is electing under section 1377(a)(2) to have the rules of section 1377(a)(1) applied as if the tax year consisted of 2 tax years. The statement must give the date and manner of the termination (e.g., sale of the shareholder's entire interest), and it must be signed by a corporate officer on behalf of the corporation. Also, the corporation must attach a statement of consent signed by each person who was a shareholder at any time during the tax year. If the election is made, write "Section 1377(a)(2) Election Made" at the top of each Schedule K-1.

Qualifying dispositions.—If a qualifying disposition takes place during the tax year, the corporation may make an irrevocable election to allocate income and expenses, etc., as if the corporation's tax year consisted of 2 tax years, the first of which ends on the close of the day on which the qualifying disposition occurs. A qualifying disposition is:

1. A disposition by a shareholder of at least 20% of the corporation's outstanding stock in one or more transactions in any 30-day period during the tax year,

2. A redemption treated as an exchange under section 302(a) or 303(a) of at least 20% of the corporation's outstanding stock in one or more transactions in any 30-day period during the tax year, or

3. An issuance of stock that equals at least 25% of the previously outstanding stock to one or more new shareholders in any 30-day period during the tax year.

To make the election, the corporation must attach a statement to a timely filed original or amended Form 1120S for the tax year for which the election is made. In the statement, the corporation must state that it is electing under Regulations section 1.1368-1(g)(2)(i) to treat the tax year as if it consisted of separate tax years. The statement must also give the facts relating to the qualifying disposition (e.g., sale, gift, stock issuance, or redemption), and state that each shareholder who held stock in the corporation during the tax year consents to the election. A corporate officer must sign the statement under penalties of perjury on behalf of the corporation. A single election statement may be filed for all elections made under this special rule for the tax year.

For more details on the election, see Regulations section 1.1368-1(g)(2).

Specific Instructions (Schedule K Only)

Enter the total pro rata share amount for each applicable line item on Schedule K.

Specific Instructions (Schedule K-1 Only)

General Information

On each Schedule K-1, complete the date spaces at the top; enter the names, addresses, and identifying numbers of the shareholder and corporation; complete items A through D; and enter the shareholder's pro rata share of each item. **Schedule K-1 must be prepared and given to each shareholder on or before the day on which Form 1120S is filed.**

Note: *Space has been provided on line 23 (Supplemental Information) of Schedule K-1 for the corporation to provide additional information to shareholders. This space, if sufficient, should be used in place of any attached schedules required for any lines on Schedule K-1, or other amounts not shown on lines 1 through 22 of Schedule K-1. Please be sure to identify the applicable line number next to the information entered below line 23.*

Special Reporting Requirements for Corporations With Multiple Activities

If items of income, loss, deduction, or credit from more than one activity (determined for purposes of the passive activity loss and credit limitations) are reported on lines 1, 2, or 3 of Schedule K-1, the corporation must provide information for each activity to its shareholders. See **Passive Activity Reporting Requirements** on page 8 for details on the reporting requirements.

Special Reporting Requirements for At-Risk Activities

If the corporation is involved in one or more at-risk activities for which a loss is reported on Schedule K-1, the corporation must report information separately for each at-risk activity. See section 465(c) for a definition of at-risk activities.

For each at-risk activity, the following information must be provided on an attachment to Schedule K-1:

1. A statement that the information is a breakdown of at-risk activity loss amounts.

2. The identity of the at-risk activity; the loss amount for the activity; other income and deductions; and other information that relates to the activity.

Specific Items

Item A

If there was no change in shareholders or in the relative interest in stock the shareholders owned during the tax year, enter the percentage of total stock owned by each shareholder during the tax year. For example, if shareholders X and Y each owned 50% for the entire tax year, enter 50% in item A for each shareholder. Each shareholder's pro rata share items (lines 1 through 20 of Schedule K-1) are figured by multiplying the Schedule K amount on the corresponding line of Schedule K by the percentage in item A.

If there was a change in shareholders or in the relative interest in stock the shareholders owned during the tax year, each shareholder's percentage of ownership is weighted for the number of days in the tax year that stock was owned. For example, A and B each held 50% for half the tax year and A, B, and C held 40%, 40%, and 20%, respectively, for the remaining half of the tax year. The percentage of ownership for the year for A, B, and C is figured as follows and is then entered in item A.

	a	b	c (a × b)	
	% of total stock owned	% of tax year held	% of ownership for the year	
A	50 40	50 50	25 +20	45
B	50 40	50 50	25 +20	45
C	20	50	10	10
Total				100%

If there was a change in shareholders or in the relative interest in stock the shareholders owned during the tax year, each shareholder's pro rata share items generally are figured by multiplying the Schedule K amount by the percentage in item A. However, if a shareholder terminated his or her entire interest in the corporation during the year or a qualifying disposition took place, the corporation may elect to allocate income and expenses, etc., as if the tax year consisted of 2 tax years, the first of which ends on the day of the termination or qualifying disposition. See **Special Rules** on page 15 for more details. Each shareholder's pro rata share items are figured separately for each period on a daily basis, based on the percentage of stock held by the shareholder on each day.

Item B

Enter the Internal Revenue Service Center address where the Form 1120S, to which a copy of this K-1 was attached, was or will be filed.

Item C

If the corporation is a registration-required tax shelter, it must enter its tax shelter registration number in item C. If the corporation invested in a registration-required shelter, the corporation must also furnish a copy of its Form 8271 to its shareholders. See Form 8271 for more information.

Specific Instructions (Schedules K and K-1, Except as Noted)

Income (Loss)

Reminder: Before entering income items on Schedule K or K-1, be sure to reduce the items of income for the following:

1. Built-in gains tax (Schedule D, Part IV, line 31).—Each recognized built-in gain item (within the meaning of section 1374(d)(3)) is reduced by its proportionate share of the built-in gains tax.

2. Capital gains tax (Schedule D, Part III, line 23).—The section 1231 gain included on line 5 or 6 of Schedule K is reduced by this tax.

3. Excess net passive income tax (line 22a, page 1, Form 1120S).—Each item of passive investment income (within the meaning of Regulations section 1.1362-2(c)(5)) is reduced by its proportionate share of the net passive income tax.

Line 1—Ordinary Income (Loss) From Trade or Business Activities

Enter the amount from line 21, page 1. Enter the income or loss without reference to **(a)** shareholders' basis in the stock of the corporation and in any indebtedness of the corporation to the shareholders (section 1366(d)), **(b)** shareholders' at-risk limitations, and **(c)** shareholders' passive activity limitations. These limitations, if applicable, are determined at the shareholder level.

If the corporation is involved in more than one trade or business activity, see **Passive Activity Reporting Requirements** on page 8 for details on the information to be reported for each activity. If an at-risk activity loss is reported on line 1, see **Special Reporting Requirements for At-Risk Activities** above.

Line 2—Net Income (Loss) From Rental Real Estate Activities

Enter the net income or loss from rental real estate activities of the corporation from **Form 8825,** Rental Real Estate Income and Expenses of a Partnership or an S Corporation. Each Form 8825 has space for reporting the income and expenses of up to eight properties.

If the corporation has income or loss from more than one rental real estate activity reported on line 2, see **Passive Activity Reporting Requirements** on page 8 for details on the information to be reported for each activity. If an at-risk activity loss is reported on line 2, see **Special Reporting Requirements for At-Risk Activities** above.

Line 3—Income and Expenses of Other Rental Activities

Enter on lines 3a and 3b of Schedule K (line 3 of Schedule K-1) the income and expenses of rental activities other than the income and expenses reported on Form

8825. If the corporation has more than one rental activity reported on line 3, see **Passive Activity Reporting Requirements** on page 8 for details on the information to be reported for each activity. If an at-risk activity loss is reported on line 3, see **Special Reporting Requirements for At-Risk Activities** on page 16. Also see **Rental activities** on page 6 for a definition and other details on other rental activities.

Lines 4a Through 4f—Portfolio Income (Loss)

Enter portfolio income (loss) on lines 4a through 4f. See **Portfolio income** on page 7 for the definition of portfolio income. Do not reduce portfolio income by deductions allocated to it. Report such deductions (other than interest expense) on line 9 of Schedules K and K-1. Interest expense allocable to portfolio income is generally investment interest expense and is reported on line 11a of Schedules K and K-1.

Lines 4a and 4b.—Enter only taxable interest and dividends that are portfolio income. Interest income derived in the ordinary course of the corporation's trade or business, such as interest charged on receivable balances, is reported on line 5, page 1, Form 1120S. See Temporary Regulations section 1.469-2T(c)(3).

Lines 4d and 4e.—Enter on line 4d the net short-term capital gain or loss from line 6 of Schedule D (Form 1120S) that is portfolio income. Enter on line 4e the net long-term capital gain or loss from line 12 of Schedule D (Form 1120S) that is portfolio income. If any gain or loss from lines 6 and 12 of Schedule D is not portfolio income (e.g., gain or loss from the disposition of nondepreciable personal property used in a trade or business), do not report this income or loss on lines 4d and 4e. Instead, report it on line 6 of Schedules K and K-1. If the income or loss is attributable to more than one activity, report the income or loss amount separately for each activity on an attachment to Schedule K-1 and identify the activity to which the income or loss relates.

Line 4f.—Enter any other portfolio income not reported on lines 4a through 4e.

If the corporation holds a residual interest in a REMIC, report on an attachment for line 4f each shareholder's share of taxable income (net loss) from the REMIC (line 1b of Schedule Q (Form 1066)); excess inclusion (line 2c of Schedule Q (Form 1066)); and section 212 expenses (line 3b of Schedule Q (Form 1066)). Because Schedule Q (Form 1066) is a quarterly statement, the corporation must follow the Schedule Q (Form 1066) Instructions for Residual Interest Holder to figure the amounts to report to shareholders for the corporation's tax year.

Line 5—Net Gain (Loss) Under Section 1231 (Other Than Due to Casualty or Theft)

Enter the gain (loss) under section 1231 shown on line 8 of Form 4797. Do not include net gains or losses from involuntary conversions due to casualties or thefts on this line. Instead, report them on line 6.

If the corporation is involved in more than one trade or business or rental activity, see **Passive Activity Reporting Requirements** on page 8 for details on the information to be reported for each activity. If an at-risk activity loss is reported on line 5, see **Special Reporting Requirements for At-Risk Activities** on page 16.

Line 6—Other Income (Loss)

Enter any other item of income or loss not included on lines 1 through 5, such as:

1. Recoveries of tax benefit items (section 111).

2. Gambling gains and losses (section 165(d)).

3. Net gain (loss) from involuntary conversions due to casualty or theft. The amount for this item is shown on **Form 4684,** Casualties and Thefts, line 38a or 38b.

4. Any net gain or loss from section 1256 contracts from **Form 6781,** Gains and Losses From Section 1256 Contracts and Straddles.

If the corporation is involved in more than one trade or business or rental activity, see **Passive Activity Reporting Requirements** on page 8 for details on the information to be reported for each activity. If an at-risk activity loss is reported on line 6, see **Special Reporting Requirements for At-Risk Activities** on page 16.

Deductions

Line 7—Charitable Contributions

Enter the amount of charitable contributions paid by the corporation during its tax year. On an attachment to Schedules K and K-1, show separately the dollar amount of contributions subject to each of the 50%, 30%, and 20% of adjusted gross income limits.

Generally, no deduction is allowed for any contribution of $250 or more unless the corporation obtains a written acknowledgement from the charitable organization that shows the amount of cash contributed, describes any property contributed, and gives an estimate of the value of any goods or services provided in return for the contribution. The acknowledgment must be obtained by the due date (including extensions) of the corporation's return, or if earlier, the date the corporation files its return. Do not attach the acknowledgment to the tax return, but keep it with the corporation's records. These rules apply in addition to the filing requirements for Form 8283 described below.

Certain contributions made to an organization conducting lobbying activities are not deductible. See section 170(f)(9) for more details.

If the corporation contributes property other than cash and the deduction claimed for such property exceeds $500, complete **Form 8283,** Noncash Charitable Contributions, and attach it to Form 1120S. The corporation must give a copy of its Form 8283 to every shareholder if the deduction for any item or group of similar items of contributed property exceeds $5,000, even if the amount allocated to any shareholder is $5,000 or less.

If the deduction for an item or group of similar items of contributed property is $5,000 or less, the corporation must report each shareholder's pro rata share of the amount of noncash contributions to enable individual shareholders to complete their own Forms 8283. See the Instructions for Form 8283 for more information.

If the corporation made a qualified conservation contribution under section 170(h), also include the fair market value of the underlying property before and after the donation, as well as the type of legal interest contributed, and describe the conservation purpose furthered by the donation. Give a copy of this information to each shareholder.

Line 8—Section 179 Expense Deduction

An S corporation may elect to expense part of the cost of certain tangible property that the corporation purchased during the tax year for use in its trade or business or certain rental activities. See the Instructions for Form 4562 for more information.

Complete Part I of Form 4562 to figure the corporation's section 179 expense deduction. The corporation does not claim the deduction itself, but instead passes it through to the shareholders. Attach Form 4562 to Form 1120S and show the total section 179 expense deduction on Schedule K, line 8. Report each individual shareholder's pro rata share on Schedule K-1, line 8. Do not complete line 8 of Schedule K-1 for any shareholder that is an estate or trust.

If the corporation is an enterprise zone business, also report on an attachment to Schedules K and K-1 the cost of section 179 property placed in service during the year that is qualified zone property.

See the instructions for line 23 of Schedule K-1, item 3, for any recapture of a section 179 amount.

Line 9—Deductions Related to Portfolio Income (Loss)

Enter on line 9 the deductions clearly and directly allocable to portfolio income (other than interest expense). Interest expense related to portfolio income is investment interest expense and is reported on line 11a of Schedules K and K-1. Generally, the line 9 expenses are section 212 expenses and are subject to section 212 limitations at the shareholder level.

Note: *No deduction is allowed under section 212 for expenses allocable to a convention, seminar, or similar meeting. Because these expenses are not deductible by shareholders, the corporation does not report these expenses on line 9 or line 10. The expenses are nondeductible*

and are reported as such on line 19 of Schedules K and K-1.

Line 10—Other Deductions

Enter any other deductions not included on lines 7, 8, 9, and 15e. On an attachment, identify the deduction and amount, and if the corporation has more than one activity, the activity to which the deduction relates.

Examples of items to be reported on an attachment to line 10 include:

- Amounts (other than investment interest required to be reported on line 11a of Schedules K and K-1) paid by the corporation that would be allowed as itemized deductions on a shareholder's income tax return if they were paid directly by a shareholder for the same purpose. These amounts include, but are not limited to, expenses under section 212 for the production of income other than from the corporation's trade or business.
- Any penalty on early withdrawal of savings not reported on line 9 because the corporation withdrew funds from its time savings deposit before its maturity.
- Soil and water conservation expenditures (section 175).
- Expenditures paid or incurred for the removal of architectural and transportation barriers to the elderly and disabled that the corporation has elected to treat as a current expense. See section 190.
- Interest expense allocated to debt-financed distributions. See Notice 89-35, 1989-1 C.B. 675, for more information.
- If there was a gain (loss) from a casualty or theft to property not used in a trade or business or for income producing purposes, provide each shareholder with the needed information to complete Form 4684.

Investment Interest

Lines 11a and 11b must be completed for all shareholders.

Line 11a—Investment Interest Expense

Include on this line the interest properly allocable to debt on property held for investment purposes. Property held for investment includes property that produces income (unless derived in the ordinary course of a trade or business) from interest, dividends, annuities, or royalties; and gains from the disposition of property that produces those types of income or is held for investment.

Investment interest expense **does not** include interest expense allocable to a passive activity.

Report investment interest expense only on line 11a of Schedules K and K-1.

The amount on line 11a will be deducted by individual shareholders on Schedule A (Form 1040), line 13, after applying the investment interest expense limitations of section 163(d).

For more information, see **Form 4952,** Investment Interest Expense Deduction.

Lines 11b(1) and 11b(2)—Investment Income and Expenses

Enter on line 11b(1) only the investment income included on lines 4a, b, c, and f of Schedule K-1. Do not include other portfolio gains or losses on this line.

Enter on line 11b(2) only the investment expense included on line 9 of Schedule K-1.

If there are other items of investment income or expense included in the amounts that are required to be passed through separately to the shareholders on Schedule K-1, such as net short-term capital gain or loss, net long-term capital gain or loss, and other portfolio gains or losses, give each shareholder a schedule identifying these amounts.

Investment income includes gross income from property held for investment, the excess of net gain attributable to the disposition of property held for investment over net capital gain from the disposition of property held for investment, and any net capital gain from the disposition of property held for investment that each shareholder elects to include in investment income under section 163(d)(4)(B)(iii). Generally, investment income and investment expenses do not include any income or expenses from a passive activity. See Regulations section 1.469-2(f)(10) for exceptions.

Property subject to a net lease is not treated as investment property because it is subject to the passive loss rules. Do not reduce investment income by losses from passive activities.

Investment expenses are deductible expenses (other than interest) directly connected with the production of investment income. See the Instructions for Form 4952 for more information on investment income and expenses.

Credits

Note: *If the corporation has credits from more than one trade or business activity on line 12a or 13, or from more than one rental activity on line 12b, 12c, 12d, or 12e, it must report separately on an attachment to Schedule K-1, the amount of each credit and provide any other applicable activity information listed in* ***Passive Activity Reporting Requirements*** *on page 8.*

Line 12a—Credit for Alcohol Used as Fuel

Enter on line 12a of Schedule K the credit for alcohol used as fuel attributable to trade or business activities. Enter on line 12d or 12e the credit for alcohol used as fuel attributable to rental activities. Figure the credit on **Form 6478,** Credit for Alcohol Used as Fuel, and attach it to Form 1120S. The credit must be included in income on page 1, line 5, of Form 1120S. See section 40(f) for an election the corporation can make to have the credit not apply.

Enter each shareholder's share of the credit for alcohol used as fuel on line 12a, 12d, or 12e of Schedule K-1.

If this credit includes the small ethanol producer credit, identify on a statement attached to each Schedule K-1 **(a)** the amount of the small producer credit included in the total credit allocated to the shareholder, **(b)** the number of gallons of qualified ethanol fuel production allocated to the shareholder, and **(c)** the shareholder's pro rata share in gallons of the corporation's productive capacity for alcohol.

Line 12b—Low-Income Housing Credit

Section 42 provides for a credit that may be claimed by owners of low-income residential rental buildings. If shareholders are eligible to claim the low-income housing credit, complete the applicable parts of **Form 8586,** Low-Income Housing Credit, and attach it to Form 1120S. Enter the credit figured by the corporation on Form 8586, and any low-income housing credit received from other entities in which the corporation is allowed to invest, on the applicable line as explained below. The corporation must also complete and attach **Form 8609,** Low-Income Housing Credit Allocation Certification, and **Schedule A (Form 8609),** Annual Statement, to Form 1120S. See the Instructions for Form 8586 and Form 8609 for information on completing these forms.

Line 12b(1).—If the corporation invested in a partnership to which the provisions of section 42(j)(5) apply, report on line 12b(1) the credit the partnership reported to the corporation on line 13a(1) of Schedule K-1 (Form 1065). If the corporation invested **before 1990** in a section 42(j)(5) partnership, also include on this line any credit the partnership reported to the corporation on line 13a(3) of Schedule K-1 (Form 1065).

Line 12b(2).—Report on line 12b(2) any low-income housing credit for property placed in service before 1990 and not reported on line 12b(1). This includes any credit from a building placed in service before 1990 in a project owned by the corporation and any credit from a partnership reported to the corporation on line 13a(2) of Schedule K-1 (Form 1065). Also include on this line any credit from a partnership reported to the corporation on line 13a(4) of Schedule K-1 (Form 1065), if the corporation invested in that partnership **before 1990.**

Line 12b(3).—If the corporation invested **after 1989** in a partnership to which the provisions of section 42(j)(5) apply, report on line 12b(3) the credit the partnership reported to the corporation on line 13a(3) of Schedule K-1 (Form 1065).

Line 12b(4).—Report on line 12b(4) any low-income housing credit for property placed in service after 1989 and not reported on any other line. This includes any credit from a building placed in service after 1989 in a project owned by the corporation and any credit from a partnership reported to the corporation on line 13a(4) of Schedule K-1 (Form 1065), if the corporation invested in that partnership **after 1989.**

Line 12c—Qualified Rehabilitation Expenditures Related to Rental Real Estate Activities

Enter total qualified rehabilitation expenditures related to rental real estate activities of the corporation. For line 12c of Schedule K, complete the applicable lines of **Form 3468,** Investment Credit, that apply to qualified rehabilitation expenditures for property related to rental real estate activities of the corporation for which income or loss is reported on line 2 of Schedule K. See Form 3468 for details on qualified rehabilitation expenditures. Attach Form 3468 to Form 1120S.

For line 12c of Schedule K-1, enter each shareholder's pro rata share of the expenditures. On the dotted line to the left of the entry space for line 12c, enter the line number of Form 3468 on which the shareholder should report the expenditures. If there is more than one type of expenditure, or the expenditures are from more than one line 2 activity, report this information separately for each expenditure or activity on an attachment to Schedules K and K-1.

Note: *Qualified rehabilitation expenditures* ***not*** *related to rental real estate activities must be listed separately on line 23 of Schedule K-1.*

Line 12d—Credits (Other Than Credits Shown on Lines 12b and 12c) Related to Rental Real Estate Activities

Enter on line 12d any other credit (other than credits on lines 12b and 12c) related to rental real estate activities. On the dotted line to the left of the entry space for line 12d, identify the type of credit. If there is more than one type of credit or the credit is from more than one line 2 activity, report this information separately for each credit or activity on an attachment to Schedules K and K-1. These credits may include any type of credit listed in the instructions for line 13.

Line 12e—Credits Related to Other Rental Activities

Enter on line 12e any credit related to other rental activities for which income or loss is reported on line 3 of Schedules K and K-1. On the dotted line to the left of the entry space for line 12e, identify the type of credit. If there is more than one type of credit or the credit is from more than one line 3 activity, report this information separately for each credit or activity on an attachment to Schedules K and K-1. These credits may include any type of credit listed in the instructions for line 13.

Line 13—Other Credits

Enter on line 13 any other credit, except credits or expenditures shown or listed for lines 12a through 12e of Schedules K and K-1 or the credit for Federal tax paid on fuels (which is reported on line 23c of page 1). On the dotted line to the left of the entry space for line 13, identify the type of credit. If there is more than one type of credit or the credit is from more than one activity, report this information separately for each credit or activity on an attachment to Schedules K and K-1.

The credits to be reported on line 13 and other required attachments are as follows:

- Nonconventional source fuel credit. Figure this credit on a separate schedule and attach it to Form 1120S. See section 29 for rules on figuring the credit.
- Unused investment credit from cooperatives. If the corporation is a member of a cooperative that passes an unused investment credit through to its members, the credit is in turn passed through to the corporation's shareholders.
- Credit for backup withholding on dividends, interest, or patronage dividends.
- Credit for increasing research activities (Form 6765).
- Jobs credit (Form 5884).
- Disabled access credit (Form 8826).
- Enhanced oil recovery credit (Form 8830).
- Qualified electric vehicle credit (Form 8834).
- Renewable electricity production credit (Form 8835).
- Empowerment zone employment credit (Form 8844).
- Indian employment credit (Form 8845).
- Credit for employer social security and Medicare taxes paid on certain employee tips (Form 8846).
- Credit for contributions to selected community development corporations (Form 8847).

See the instructions on pages 21 and 22 for line 21 (Schedule K) and line 23 (Schedule K-1) to report expenditures qualifying for the **(a)** rehabilitation credit not related to rental real estate activities, **(b)** energy credit, or **(c)** reforestation credit.

Adjustments and Tax Preference Items

Lines 14a through 14e must be completed for all shareholders.

Enter items of income and deductions that are adjustments or tax preference items. Get **Form 6251,** Alternative Minimum Tax—Individuals, or Schedule I of **Form 1041,** U.S. Income Tax Return for Estates and Trusts, to determine the amounts to enter and for other information.

Do not include as a tax preference item any qualified expenditures to which an election under section 59(e) may apply. Because these expenditures are subject to an election by each shareholder, the corporation cannot figure the amount of any tax preference related to them. Instead, the corporation must pass through to each shareholder on lines 16a and 16b of Schedule K-1 the information needed to figure the deduction.

Line 14a—Depreciation Adjustment on Property Placed in Service After 1986

Figure the adjustment for line 14a based only on tangible property placed in service after 1986 (and tangible property placed in service after July 31, 1986, and before 1987 for which the corporation elected to use the General Depreciation System). **Do not** make an adjustment for motion picture films, videotapes, sound recordings, certain public utility property (as defined in section 168(f)(2)), or property depreciated under the unit-of-production method (or any other method not expressed in a term of years).

Using the same convention the corporation used for regular tax purposes, refigure depreciation as follows:

- For property that is neither real property nor property depreciated using the straight line method, use the 150% declining balance method over the property's class life (instead of the recovery period), switching to straight line for the first tax year that method gives a better result. See Pub. 946 for a table of class lives. For property having no class life, use 12 years.
- For property depreciated using the straight line method (other than real property), use the straight line method over the property's class life (instead of the recovery period). For property having no class life, use 12 years.
- For residential rental and nonresidential real property, use the straight line method over 40 years.

Determine the depreciation adjustment by subtracting the refigured depreciation from the depreciation claimed on Form 4562. If the refigured depreciation exceeds the depreciation claimed on Form 4562, enter the difference as a negative amount. See the instructions for Form 6251 and Form 4562 for more information.

Line 14b—Adjusted Gain or Loss

If the corporation disposed of any tangible property placed in service after 1986 (or after July 31, 1986, if an election was made to use the General Depreciation System), or if it disposed of a certified pollution control facility placed in service after 1986, refigure the gain or loss from the disposition using the adjusted basis for alternative minimum tax (AMT) purposes. The property's adjusted basis for AMT purposes is its cost or other basis minus all depreciation or amortization deductions allowed or allowable for AMT purposes during the current tax year and previous tax years. Enter on this line the difference between the regular tax gain (or loss) and the AMT gain (or loss). If the AMT gain is less than the regular tax gain, OR the AMT loss is more than the regular tax loss, OR there is an AMT loss and a regular tax gain, enter the difference as a negative amount.

Line 14c—Depletion (Other Than Oil and Gas)

Do not include any depletion on oil and gas wells. The shareholders must figure their depletion deductions separately under section 613A.

In the case of mines, wells, and other natural deposits, other than oil and gas wells, enter the amount by which the deduction for depletion under section 611 (including percentage depletion for geothermal deposits) is more than the adjusted basis of such property at the end of the tax year. Figure the adjusted basis without regard to the depletion deduction and figure the excess separately for each property.

Lines 14d(1) and 14d(2)

Generally, the amounts to be entered on these lines are only the income and deductions for oil, gas, and geothermal properties that are used to figure the amount on line 21, page 1, Form 1120S.

If there are any items of income or deductions for oil, gas, and geothermal properties included in the amounts that are required to be passed through separately to the shareholders on Schedule K-1, give each shareholder a schedule that shows, for the line on which the income or deduction is included, the amount of income or deductions included in the total amount for that line. Do not include any of these direct passthrough amounts on line 14d(1) or 14d(2). The shareholder is told in the Shareholder's Instructions for Schedule K-1 (Form 1120S) to adjust the amounts on lines 14d(1) and 14d(2) for any other income or deductions from oil, gas, or geothermal properties included on lines 2 through 10 and 23 of Schedule K-1 in order to determine the total income and deductions from oil, gas, and geothermal properties for the corporation.

Figure the amounts for lines 14d(1) and 14d(2) separately for oil and gas properties which are not geothermal deposits and for all properties that are geothermal deposits.

Give the shareholders a schedule that shows the separate amounts included in the computation of the amounts on lines 14d(1) and 14d(2).

Line 14d(1). Gross income from oil, gas, and geothermal properties.—Enter the total amount of gross income (within the meaning of section 613(a)) from all oil, gas, and geothermal properties received or accrued during the tax year and included on page 1, Form 1120S.

Line 14d(2). Deductions allocable to oil, gas, and geothermal properties.—Enter the amount of any deductions allocable to oil, gas, and geothermal properties reduced by the excess intangible drilling costs included on page 1, Form 1120S, on properties for which the corporation made an election to expense intangible drilling costs in tax years beginning before 1983. Do not include nonproductive well costs included on page 1.

Figure excess intangible drilling costs as follows: From the allowable intangible drilling and development costs (except for costs in drilling a nonproductive well), subtract the amount that would have been allowable if the corporation had capitalized these costs and either amortized them over the 120 months that started when production began, or treated them according to any election the corporation made under section 57(b)(2).

See section 57(a)(2) for more information.

Line 14e—Other Adjustments and Tax Preference Items

Attach a schedule that shows each shareholder's share of other items not shown on lines 14a through 14d(2) that are adjustments or tax preference items or that the shareholder needs to complete Form 6251 or Schedule I of Form 1041. See these forms and their instructions to determine the amount to enter. Other adjustments or tax preference items include the following:

- Accelerated depreciation of real property under pre-1987 rules.
- Accelerated depreciation of leased personal property under pre-1987 rules.
- Long-term contracts entered into after February 28, 1986. Except for certain home construction contracts, the taxable income from these contracts must be figured using the percentage of completion method of accounting for alternative minimum tax purposes.
- Installment sales after March 1, 1986, of property held primarily for sale to customers in the ordinary course of the corporation's trade or business. Generally, the installment method may not be used for these sales in figuring alternative minimum taxable income.
- Losses from tax shelter farm activities. No loss from any tax shelter farm activity is allowed for alternative minimum tax purposes.

Foreign Taxes

Lines 15a through 15g must be completed whether or not a shareholder is eligible for the foreign tax credit, if the corporation has foreign income, deductions, or losses, or has paid or accrued foreign taxes.

In addition to the instructions below, see **Form 1116,** Foreign Tax Credit (Individual, Estate, Trust, or Nonresident Alien Individual), and the related instructions.

Line 15a—Type of Income

Enter the type of income from outside the United States as follows:

- Passive income.
- High withholding tax interest.
- Financial services income.
- Shipping income.
- Dividends from a DISC or former DISC.
- Certain distributions from a foreign sales corporation (FSC) or former FSC.
- Dividends from each noncontrolled section 902 corporation.
- Taxable income attributable to foreign trade income (within the meaning of section 923(b)).
- General limitation income (all other income from sources outside the United States, including income from sources within U.S. possessions).

If, for the country or U.S. possession shown on line 15b, the corporation had more than one type of income, enter "See attached" and attach a schedule for each type of income for lines 15c through 15g.

Line 15b—Foreign Country or U.S. Possession

Enter the name of the foreign country or U.S. possession. If, for the type of income shown on line 15a, the corporation had income from, or paid taxes to, more than one foreign country or U.S. possession, enter "See attached" and attach a schedule for each country for lines 15a and 15c through 15g.

Line 15c—Total Gross Income From Sources Outside the United States

Enter in U.S. dollars the total gross income from sources outside the United States. Attach a schedule that shows each type of income listed in the instructions for line 15a.

Line 15d—Total Applicable Deductions and Losses

Enter in U.S. dollars the total applicable deductions and losses attributable to income on line 15c. Attach a schedule that shows each type of deduction or loss as follows:

- Expenses directly allocable to each type of income listed above.
- Pro rata share of all other deductions not directly allocable to specific items of income.
- Pro rata share of losses from other separate limitation categories.

Line 15e—Total Foreign Taxes

Enter in U.S. dollars the total foreign taxes (described in section 901) paid or accrued by the corporation to foreign countries or U.S. possessions. Attach a schedule that shows the dates the taxes were paid or accrued, and the amount in both foreign currency and in U.S. dollars, as follows:

- Taxes withheld at source on dividends.
- Taxes withheld at source on rents and royalties.
- Other foreign taxes paid or accrued.

Line 15f—Reduction in Taxes Available for Credit

Enter in U.S. dollars the total reduction in taxes available for credit. Attach a schedule that shows separately the:

- Reduction for foreign mineral income.
- Reduction for failure to furnish returns required under section 6038.
- Reduction for taxes attributable to boycott operations (section 908).
- Reduction for foreign oil and gas extraction income (section 907(a)).

- Reduction for any other items (specify).

Line 15g—Other Foreign Tax Information

Enter in U.S. dollars any items not covered on lines 15c through 15f that shareholders need to complete Form 1116 (e.g., gross income from all sources).

Other

Lines 16a and 16b—Section 59(e)(2) Expenditures

Generally, section 59(e) allows each shareholder to make an election to deduct the shareholder's pro rata share of the corporation's otherwise deductible qualified expenditures ratably over 10 years (3 years for circulation expenditures), beginning with the tax year in which the expenditures were made (or for intangible drilling and development costs, over the 60-month period beginning with the month in which such costs were paid or incurred). The term "qualified expenditures" includes only the following types of expenditures paid or incurred during the tax year: circulation expenditures, research and experimental expenditures, intangible drilling and development costs, and mining exploration and development costs. If a shareholder makes this election, these items are not treated as tax preference items.

Because the shareholders are generally allowed to make this election, the corporation cannot deduct these amounts or include them as adjustments or tax preference items on Schedule K-1. Instead, on lines 16a and 16b of Schedule K-1, the corporation passes through the information the shareholders need to figure their separate deductions.

On line 16a, enter the type of expenditures claimed on line 16b. Enter on line 16b the qualified expenditures paid or incurred during the tax year to which an election under section 59(e) may apply. Enter this amount for all shareholders whether or not any shareholder makes an election under section 59(e). If the expenditures are for intangible drilling and development costs, enter the month in which the expenditures were paid or incurred (after the type of expenditures on line 16a). If there is more than one type of expenditure included in the total shown on line 16b (or intangible drilling and development costs were paid or incurred for more than 1 month), report this information separately for each type of expenditure (or month) on an attachment to Schedules K and K-1.

Line 17—Tax-Exempt Interest Income

Enter on line 17 tax-exempt interest income, including any exempt-interest dividends received from a mutual fund or other regulated investment company. This information must be reported by individuals on line 8b of Form 1040. Generally, the basis of the shareholder's stock is increased by the amount shown on this line under section 1367(a)(1)(A).

Line 18—Other Tax-Exempt Income

Enter on line 18 all income of the corporation exempt from tax other than tax-exempt interest (e.g., life insurance proceeds). Generally, the basis of the shareholder's stock is increased by the amount shown on this line under section 1367(a)(1)(A).

Line 19—Nondeductible Expenses

Enter on line 19 nondeductible expenses paid or incurred by the corporation. Do not include separately stated deductions shown elsewhere on Schedules K and K-1, capital expenditures, or items the deduction for which is deferred to a later tax year. Generally, the basis of the shareholder's stock is decreased by the amount shown on this line under section 1367(a)(2)(D).

Line 20

Enter total distributions made to each shareholder other than dividends reported on line 22 of Schedule K. Noncash distributions of appreciated property are valued at fair market value. See **Distributions** on page 23 for the ordering rules on distributions.

Line 21 (Schedule K Only)

Attach a statement to Schedule K to report the corporation's total income, expenditures, or other information for items 1 through 15 of the line 23 (Schedule K-1 Only) instruction below.

Line 22 (Schedule K Only)

Enter total dividends paid to shareholders from accumulated earnings and profits. Report these dividends to shareholders on Form 1099-DIV. Do not report them on Schedule K-1.

Lines 22a and 22b (Schedule K-1 Only)—Recapture of Low-Income Housing Credit

If recapture of part or all of the low-income housing credit is required because **(a)** prior year qualified basis of a building decreased or **(b)** the corporation disposed of a building or part of its interest in a building, get **Form 8611,** Recapture of Low-Income Housing Credit. The instructions for Form 8611 indicate when Form 8611 is completed by the corporation and what information is provided to shareholders when recapture is required.

Note: *If a shareholder's ownership interest in a building decreased because of a transaction at the shareholder level, the corporation must provide the necessary information to the shareholder to enable the shareholder to figure the recapture.*

If the corporation filed **Form 8693,** Low-Income Housing Credit Disposition Bond, to avoid recapture of the low-income housing credit, no entry should be made on line 22 of Schedule K-1.

See Form 8586, Form 8611, and section 42 for more information.

Supplemental Information

Line 23 (Schedule K-1 Only)

Enter in the line 23 Supplemental Information space of Schedule K-1, or on an attached schedule if more space is needed, each shareholder's share of any information asked for on lines 1 through 22 that is required to be reported in detail, and items **1** through **15** below. Please identify the applicable line number next to the information entered in the Supplemental Information space. Show income or gains as a positive number. Show losses in parentheses.

1. Taxes paid on undistributed capital gains by a regulated investment company. As a shareholder of a regulated investment company, the corporation will receive notice on **Form 2439,** Notice to Shareholder of Undistributed Long-Term Capital Gains, that the company paid tax on undistributed capital gains.

2. Gross income and other information relating to oil and gas well properties that are reported to shareholders to allow them to figure the depletion deduction for oil and gas well properties. See section 613A(c)(11) for details.

The corporation cannot deduct depletion on oil and gas wells. Each shareholder must determine the allowable amount to report on his or her return. See Pub. 535 for more information.

3. Recapture of section 179 expense deduction. For property placed in service after 1986, the section 179 deduction is recaptured at any time the business use of property drops to 50% or less. Enter the amount originally passed through and the corporation's tax year in which it was passed through. Inform the shareholder if the recapture amount was caused by the disposition of the section 179 property. See section 179(d)(10) for more information. Do not include this amount on line 4 or 5, page 1, Form 1120S.

4. Recapture of certain mining exploration expenditures (section 617).

5. Any information or statements the corporation is required to furnish to shareholders to allow them to comply with requirements under section 6111 (registration of tax shelters) or section 6662(d)(2)(B)(ii) (regarding adequate disclosure of items that may cause an understatement of income tax).

6. If the corporation is involved in farming or fishing activities, report the gross income from these activities to shareholders.

7. Any information needed by a shareholder to compute the interest due under section 453(l)(3). If the corporation elected to report the dispositions of certain timeshares and residential lots on the installment method, each shareholder's tax liability must be increased by the shareholder's pro rata share of the interest on tax attributable to the installment payments received during the tax year.

8. Any information needed by a shareholder to compute the interest due under section 453A(c). If an obligation arising from the disposition of property to which section 453A applies is outstanding at the close of the year, each shareholder's tax liability must be increased by the tax due under section 453A(c) on the shareholder's pro rata share of the tax deferred under the installment method.

9. Any information needed by a shareholder to properly capitalize interest as required by section 263A(f). See **Section 263A uniform capitalization rules** on page 10 for more information.

10. If the corporation is a closely held S corporation (defined in section 460(b)) and it entered into any long-term contracts after February 28, 1986, that are accounted for under either the percentage of completion-capitalized cost method or the percentage of completion method, it must attach a schedule to Form 1120S showing the information required in items (a) and (b) of the instructions for lines 1 and 3 of Part II for **Form 8697,** Interest Computation Under the Look-Back Method for Completed Long-Term Contracts. It must also report the amounts for Part II, lines 1 and 3, to its shareholders. See the instructions for Form 8697 for more information.

11. Expenditures qualifying for the **(a)** rehabilitation credit not related to rental real estate activities, **(b)** energy credit, or **(c)** reforestation credit. Complete and attach Form 3468 to Form 1120S. See Form 3468 and related instructions for information on eligible property and the lines on Form 3468 to complete. Do not include that part of the cost of the property the corporation has elected to expense under section 179. Attach to each Schedule K-1 a separate schedule in a format similar to that shown on Form 3468 detailing each shareholder's pro rata share of qualified expenditures. Also indicate the lines of Form 3468 on which the shareholders should report these amounts.

12. Recapture of investment credit. Complete and attach **Form 4255,** Recapture of Investment Credit, when investment credit property is disposed of, or it no longer qualifies for the credit, before the end of the recapture period or the useful life applicable to the property. State the type of property at the top of Form 4255, and complete lines 2, 3, 4, and 8, whether or not any shareholder is subject to recapture of the credit. Attach to each Schedule K-1 a separate schedule providing the information the corporation is required to show on Form 4255, but list only the shareholder's pro rata share of the cost of the property subject to recapture. Also indicate the lines of Form 4255 on which the shareholders should report these amounts.

The corporation itself is liable for investment credit recapture in certain cases. See the instructions for line 22c, page 1, Form 1120S, for details.

13. Any information needed by a shareholder to compute the recapture of the qualified electric vehicle credit. See Pub. 535 for more information.

14. Any information a shareholder may need to figure recapture of the Indian employment credit. Generally, if the corporation terminates a qualified employee less than 1 year after the date of initial employment, any Indian employment credit allowed for a prior tax year by reason of wages paid or incurred to that employee must be recaptured. For details, see section 45A(d).

15. Any other information the shareholders need to prepare their tax returns.

Specific Instructions

Schedule L—Balance Sheets

The balance sheets should agree with the corporation's books and records. Include certificates of deposit as cash on line 1 of Schedule L.

Line 5—Tax-Exempt Securities

Include on this line—

1. State and local government obligations, the interest on which is excludible from gross income under section 103(a), and

2. Stock in a mutual fund or other regulated investment company that distributed exempt-interest dividends during the tax year of the corporation.

Line 24—Retained Earnings

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

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

Line 3b—Travel and Entertainment

Include on this line 50% of meals and entertainment not allowed under section 274(n); expenses for the use of an entertainment facility; the part of business gifts over $25; expenses of an individual allocable to conventions on cruise ships over $2,000; employee achievement awards over $400; the part of the cost of entertainment tickets that exceeds face value (also subject to 50% disallowance); the part of the cost of skyboxes that exceeds the face value of nonluxury box seat tickets; the part of the cost of luxury water travel not allowed under section 274(m); expenses for travel as a form of education; nondeductible club dues; and other travel and entertainment expenses not allowed as a deduction.

Schedule M-2—Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed

Column (a)—Accumulated Adjustments Account

The accumulated adjustments account (AAA) is an account of the S corporation that generally reflects the accumulated undistributed net income of the corporation for the corporation's post-1982 years. S corporations with accumulated earnings and profits must maintain the AAA to determine the tax effect of distributions during S years and the post-termination transition period. An S corporation without accumulated earnings and profits does not need to maintain the AAA in order to determine the tax effect of distributions. Nevertheless, if an S corporation without accumulated earnings and profits engages in certain transactions to which section 381(a) applies, such as a merger into an S corporation with accumulated earnings and profits, the S corporation must be able to calculate its AAA at the time of the merger for purposes of determining the tax effect of post-merger distributions. Therefore, it is recommended that the AAA be maintained by all S corporations.

At the end of the tax year, the AAA is determined by taking into account the taxable income, deductible losses and expenses, and nondeductible losses and expenses for the tax year (other than expenses related to tax-exempt income and Federal taxes attributable to a C corporation tax year). See Regulations section 1.1368-2. After the year-end income and expense adjustments are made, the AAA is reduced by distributions made during the tax year. See **Distributions** on page 23 for distribution rules. For adjustments to the AAA for redemptions, reorganizations, and corporate separations, see Regulations section 1.1368-2(d).

Note: *The AAA may have a negative balance at year end. See section 1368(e).*

Column (b)—Other Adjustments Account

The other adjustments account is adjusted for tax-exempt income (and related expenses) and Federal taxes attributable to a C corporation tax year. After these adjustments are made, the account is reduced for any distributions made during the year. See **Distributions** on page 23.

Column (c)—Shareholders' Undistributed Taxable Income Previously Taxed

The shareholders' undistributed taxable income previously taxed account, also called previously taxed income (PTI), is maintained only if the corporation had a balance in this account at the start of its 1995 tax year. If there is a beginning

balance for the 1995 tax year, no adjustments are made to the account except to reduce the account for distributions made under section 1375(d) (as in effect before the enactment of the Subchapter S Revision Act of 1982). See **Distributions** below for the order of distributions from the account.

Each shareholder's right to nontaxable distributions from PTI is personal and cannot be transferred to another person. The corporation is required to keep records of each shareholder's net share of PTI.

Distributions

General rule.—Unless the corporation makes one of the elections described below, property distributions (including cash) are applied in the following order to reduce accounts of the S corporation that are used to figure the tax effect of distributions made by the corporation to its shareholders:

1. Reduce AAA (but not below zero). If distributions during the tax year exceed the AAA at the close of the tax year, the AAA is allocated pro rata to each distribution made during the tax year. See section 1368(c).

2. Reduce shareholders' PTI account for any section 1375(d) (as in effect before 1983) distributions. A distribution from the PTI account is tax free to the extent of a shareholder's basis in his or her stock in the corporation.

3. Reduce accumulated E&P. Generally, the S corporation has accumulated E&P only if it has not distributed E&P accumulated in prior years when the S corporation was a C corporation (section 1361(a)(2)) or a small business corporation prior to 1983 (section 1371 of prior law). See section 312 for information on E&P. The only adjustments that can be made to the accumulated E&P of an S corporation are **(a)** reductions for dividend distributions; **(b)** adjustments for redemptions, liquidations, reorganizations, etc.; and **(c)** reductions for investment credit recapture tax for which the corporation is liable. See sections 1371(c) and (d)(3).

4. Reduce the other adjustments account.

5. Reduce any remaining shareholders' equity accounts.

Elections relating to source of distributions.—The corporation may modify the above ordering rules by making one or more of the following elections:

1. Election to distribute accumulated E&P first.—If the corporation has accumulated E&P and wants to distribute this E&P before making distributions from the AAA, it may elect to do so with the consent of all its affected shareholders (section 1368(e)(3)(B)). This election is irrevocable and applies only for the tax year for which it is made. For details on making the election, see **Statement regarding elections** below.

2. Election to make a deemed dividend.—If the corporation wants to distribute all or part of its subchapter C E&P through a deemed dividend, it may elect to do so with the consent of all its affected shareholders (section 1368(e)(3)(B)). Under this election, the corporation will be treated as also having made the election to distribute accumulated E&P first. The amount of the deemed dividend cannot exceed the subchapter C E&P at the end of the tax year, reduced by any actual distributions of subchapter C E&P made during the tax year. A deemed dividend is treated as if it were a pro rata distribution of money to the shareholders, received by the shareholders, and immediately contributed back to the corporation, all on the last day of the tax year. This election is irrevocable and applies only for the tax year for which it is made. For details on making the election, see **Statement regarding elections** below.

3. Election to forego PTI.—If the corporation wants to forego distributions of PTI, it may elect to do so with the consent of all its affected shareholders (section 1368(e)(3)(B)). Under this election, paragraph 2 under the **General rule** above does not apply to any distribution made during the tax year. This election is irrevocable and applies only for the tax year for which it is made. For details on making the election, see **Statement regarding elections** below.

Statement regarding elections.—To make any of the above elections, the corporation must attach a statement to a timely filed original or amended Form 1120S for the tax year for which the election is made. In the statement, the corporation must identify the election it is making and must state that each shareholder consents to the election. A corporate officer must sign the statement under penalties of perjury on behalf of the corporation. The statement of election to make a deemed dividend must include the amount of the deemed dividend distributed to each shareholder.

Example

The following example shows how the Schedule M-2 accounts are adjusted for items of income (loss), deductions, and distributions reported on Form 1120S.

Items per return are:

1. Page 1, line 21 income—$219,000

2. Schedule K, line 2 loss—($3,000)

3. Schedule K, line 4a income—$4,000

4. Schedule K, line 4b income—$16,000

5. Schedule K, line 7 deduction—$24,000

6. Schedule K, line 8 deduction— $3,000

7. Schedule K, line 13 jobs credit—$6,000

8. Schedule K, line 17 tax-exempt interest—$5,000

9. Schedule K, line 19 nondeductible expenses—$6,000 (reduction in salaries and wages for jobs credit), and

10. Schedule K, line 20 distributions—$65,000.

Based on return items 1 through 10 and starting balances of zero, the columns for the AAA and the other adjustments account are completed as shown in the Schedule M-2 Worksheet below.

Note: *For the AAA account, the worksheet line 3—$20,000 amount is the total of the Schedule K, lines 4a and 4b incomes of $4,000 and $16,000. The worksheet line 5—$36,000 amount is the total of the Schedule K, line 2 loss of ($3,000), line 7 deduction of $24,000, line 8 deduction of $3,000, and the line 19 nondeductible expenses of $6,000. For the other adjustments account, the worksheet line 3 amount is the Schedule K, line 17, tax-exempt interest income of $5,000. Other worksheet amounts are self-explanatory.*

Schedule M-2 **Worksheet**

		(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1	Balance at beginning of tax year	-0-	-0-	
2	Ordinary income from page 1, line 21	219,000		
3	Other additions	20,000	5,000	
4	Loss from page 1, line 21	( )		
5	Other reductions	(36,000)	( )	
6	Combine lines 1 through 5	203,000	5,000	
7	Distributions other than dividend distributions	65,000	-0-	
8	Balance at end of tax year. Subtract line 7 from line 6	138,000	5,000	

Codes for Principal Business Activity

These codes for the Principal Business Activity are designed to classify enterprises by the type of activity in which they are engaged to facilitate the administration of the Internal Revenue Code. Though similar in format and structure to the Standard Industrial Classification (SIC) codes, they should not be used as SIC codes.

Using the list below, enter on page 1, under B, the code number for the specific industry group from which the largest percentage of "total receipts" is derived. Total receipts means the total of: gross receipts on line 1a, page 1; all other income on lines 4 and 5, page 1; all income on lines 2, 19, and 20a of Form 8825; and income (receipts only) on lines 3a and 4a through 4f of Schedule K.

On page 2, Schedule B, line 2, state the principal business activity and principal product or service that account for the largest percentage of total receipts. For example, if the principal business activity is "Grain mill products," the principal product or service may be "Cereal preparations."

If, as its principal business activity, the corporation: (1) purchases raw materials, (2) subcontracts out for labor to make a finished product from the raw materials, and (3) retains title to the goods, the corporation is considered to be a manufacturer and must enter one of the codes (2010–3998) under "Manufacturing."

Agriculture, Forestry, and Fishing

Code

0400 Agricultural production.
0600 Agricultural services (except veterinarians), forestry, fishing, hunting, and trapping.

Mining

Metal mining:
1010 Iron ores.
1070 Copper, lead and zinc, gold and silver ores.
1098 Other metal mining.
1150 Coal mining.

Oil and gas extraction:
1330 Crude petroleum, natural gas, and natural gas liquids.
1380 Oil and gas field services.

Nonmetallic minerals, except fuels:
1430 Dimension, crushed and broken stone; sand and gravel.
1498 Other nonmetallic minerals, except fuels.

Construction

General building contractors and operative builders:
1510 General building contractors.
1531 Operative builders.

1600 Heavy construction contractors.

Special trade contractors:
1711 Plumbing, heating, and air conditioning.
1731 Electrical work.
1798 Other special trade contractors.

Manufacturing

Food and kindred products:
2010 Meat products.
2020 Dairy products.
2030 Preserved fruits and vegetables.
2040 Grain mill products.
2050 Bakery products.
2060 Sugar and confectionery products.
2081 Malt liquors and malt.
2088 Alcoholic beverages, except malt liquors and malt.
2089 Bottled soft drinks, and flavorings.
2096 Other food and kindred products.

2100 Tobacco manufacturers.

Textile mill products:
2228 Weaving mills and textile finishing.
2250 Knitting mills.
2298 Other textile mill products.

Apparel and other textile products:
2315 Men's and boys' clothing.
2345 Women's and children's clothing.
2388 Other apparel and accessories.
2390 Miscellaneous fabricated textile products.

Lumber and wood products:
2415 Logging, sawmills, and planing mills.
2430 Millwork, plywood, and related products.
2498 Other wood products, including wood buildings and mobile homes.

2500 Furniture and fixtures.

Paper and allied products:
2625 Pulp, paper, and board mills.
2699 Other paper products.

Printing and publishing:
2710 Newspapers.
2720 Periodicals.
2735 Books, greeting cards, and miscellaneous publishing.
2799 Commercial and other printing, and printing trade services.

Code

Chemicals and allied products:
2815 Industrial chemicals, plastics materials and synthetics.
2830 Drugs.
2840 Soap, cleaners, and toilet goods.
2850 Paints and allied products.
2898 Agricultural and other chemical products.

Petroleum refining and related industries (including those integrated with extraction):
2910 Petroleum refining (including integrated).
2998 Other petroleum and coal products.

Rubber and misc. plastics products:
3050 Rubber products: plastics footwear, hose, and belting.
3070 Misc. plastics products.

Leather and leather products:
3140 Footwear, except rubber.
3198 Other leather and leather products.

Stone, clay, and glass products:
3225 Glass products.
3240 Cement, hydraulic.
3270 Concrete, gypsum, and plaster products.
3298 Other nonmetallic mineral products.

Primary metal industries:
3370 Ferrous metal industries; misc. primary metal products.
3380 Nonferrous metal industries.

Fabricated metal products:
3410 Metal cans and shipping containers.
3428 Cutlery, hand tools, and hardware; screw machine products, bolts, and similar products.
3430 Plumbing and heating, except electric and warm air.
3440 Fabricated structural metal products.
3460 Metal forgings and stampings.
3470 Coating, engraving, and allied services.
3480 Ordnance and accessories, except vehicles and guided missiles.
3490 Misc. fabricated metal products.

Machinery, except electrical:
3520 Farm machinery.
3530 Construction and related machinery.
3540 Metalworking machinery.
3550 Special industry machinery.
3560 General industrial machinery.
3570 Office, computing, and accounting machines.
3598 Other machinery except electrical.

Electrical and electronic equipment:
3630 Household appliances.
3665 Radio, television, and communications equipment.
3670 Electronic components and accessories.
3698 Other electrical equipment.

3710 Motor vehicles and equipment.

Transportation equipment, except motor vehicles:
3725 Aircraft, guided missiles and parts.
3730 Ship and boat building and repairing.
3798 Other transportation equipment, except motor vehicles.

Instruments and related products:
3815 Scientific instruments and measuring devices; watches and clocks.
3845 Optical, medical, and ophthalmic goods.
3860 Photographic equipment and supplies.

3998 Other manufacturing products.

Transportation and Public Utilities

Code

Transportation:
4000 Railroad transportation.
4100 Local and interurban passenger transit.
4200 Trucking and warehousing.
4400 Water transportation.
4500 Transportation by air.
4600 Pipe lines, except natural gas.
4700 Miscellaneous transportation services.

Communication:
4825 Telephone, telegraph, and other communication services.
4830 Radio and television broadcasting.

Electric, gas, and sanitary services:
4910 Electric services.
4920 Gas production and distribution.
4930 Combination utility services.
4990 Water supply and other sanitary services.

Wholesale Trade

Durable:
5008 Machinery, equipment, and supplies.
5010 Motor vehicles and automotive equipment.
5020 Furniture and home furnishings.
5030 Lumber and construction materials.
5040 Sporting, recreational, photographic, and hobby goods, toys and supplies.
5050 Metals and minerals, except petroleum and scrap.
5060 Electrical goods.
5070 Hardware, plumbing and heating equipment and supplies.
5098 Other durable goods.

Nondurable:
5110 Paper and paper products.
5129 Drugs, drug proprietaries, and druggists' sundries.
5130 Apparel, piece goods, and notions.
5140 Groceries and related products.
5150 Farm-product raw materials.
5160 Chemicals and allied products.
5170 Petroleum and petroleum products.
5180 Alcoholic beverages.
5190 Misc. nondurable goods.

Retail Trade

Building materials, garden supplies, and mobile home dealers:
5220 Building materials dealers.
5251 Hardware stores.
5265 Garden supplies and mobile home dealers.

5300 General merchandise stores.

Food stores:
5410 Grocery stores.
5490 Other food stores.

Automotive dealers and service stations:
5515 Motor vehicle dealers.
5541 Gasoline service stations.
5598 Other automotive dealers.

5600 Apparel and accessory stores.

5700 Furniture and home furnishings stores.

5800 Eating and drinking places.

Misc. retail stores:
5912 Drug stores and proprietary stores.
5921 Liquor stores.
5995 Other retail stores.

Finance, Insurance, and Real Estate

Code

Banking:
6030 Mutual savings banks.
6060 Bank holding companies.
6090 Banks, except mutual savings banks and bank holding companies.

Credit agencies other than banks:
6120 Savings and loan associations.
6140 Personal credit institutions.
6150 Business credit institutions.
6199 Other credit agencies.

Security, commodity brokers and services:
6210 Security brokers, dealers, and flotation companies.
6299 Commodity contracts brokers and dealers; security and commodity exchanges; and allied services.

Insurance:
6355 Life Insurance.
6356 Mutual insurance, except life or marine and certain fire or flood insurance companies.
6359 Other insurance companies.
6411 Insurance agents, brokers, and service.

Real estate:
6511 Real estate operators and lessors of buildings.
6516 Lessors of mining, oil, and similar property.
6518 Lessors of railroad property and other real property.
6530 Condominium management and cooperative housing associations.
6550 Subdividers and developers.
6599 Other real estate.

Holding and other investment companies, except bank holding companies:
6744 Small business investment companies.
6749 Other holding and investment companies, except bank holding companies.

Services

7000 Hotels and other lodging places.
7200 Personal services.

Business services:
7310 Advertising.
7389 Business services, except advertising.

Auto repair; miscellaneous repair services:
7500 Auto repair and services.
7600 Misc. repair services.

Amusement and recreation services:
7812 Motion picture production, distribution, and services.
7830 Motion picture theaters.
7900 Amusement and recreation services, except motion pictures.

Other services:
8015 Offices of physicians, including osteopathic physicians.
8021 Offices of dentists.
8040 Offices of other health practitioners.
8050 Nursing and personal care facilities.
8060 Hospitals.
8071 Medical laboratories.
8099 Other medical services.
8111 Legal services.
8200 Educational services.
8300 Social services.
8600 Membership organizations.
8911 Architectural and engineering services.
8930 Accounting, auditing, and bookkeeping.
8980 Miscellaneous services (including veterinarians).

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