



Instructions for Form 1120S

U.S. Income Tax Return for an S Corporation

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

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Photographs of Missing Children

The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in instructions on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1-800-THE-LOST** (1-800-843-5678) if you recognize a child.

Unresolved Tax Issues

If the corporation has attempted to deal with an IRS problem unsuccessfully, it should contact the Taxpayer Advocate. The Taxpayer Advocate independently represents the corporation's interests and concerns within the IRS by protecting its rights and resolving problems that have not been fixed through normal channels.

While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that the corporation's case is given a complete and impartial review.

The corporation's assigned personal advocate will listen to its point of view and will work with the corporation to address its concerns. The corporation can expect the advocate to provide:

- A "fresh look" at a new or on-going problem.
- Timely acknowledgment.
- The name and phone number of the individual assigned to its case.
- Updates on progress.
- Timeframes for action.
- Speedy resolution.
- Courteous service.

When contacting the Taxpayer Advocate, the corporation should provide the following information:

- The corporation's name, address, and employer identification number (EIN).
- The name and telephone number of an authorized contact person and the hours he or she can be reached.
- The type of tax return and year(s) involved.
- A detailed description of the problem.
- Previous attempts to solve the problem and the office that had been contacted.
- A description of the hardship the corporation is facing (if applicable).

The corporation may contact a Taxpayer Advocate by calling a toll-free number, **1-877-777-4778**. Persons who

Changes To Note

- The corporation may need to mail its return to a different service center this year because the IRS has changed the filing location for several areas. If an envelope was received with the tax package, please use it. Otherwise, see **Where To File** on page 3.

- The corporation may request that the IRS deposit its income tax refund directly into an account at any U.S. bank or other financial institution that accepts direct deposits. For details, see the instructions for line 27 on page 16, and new **Form 8050**, Direct Deposit of Corporate Tax Refund.

- If the corporation wants to allow the IRS to discuss its 2001 tax return with the paid preparer who signed it, check the "Yes" box in the area where the officer of the corporation signed the return. See page 3 for details.

have access to TTY/TDD equipment may call 1-800-829-4059 and ask for Taxpayer Advocate assistance. If the corporation prefers, it may call, write, or fax the Taxpayer Advocate office in its area. See **Pub. 1546**, The Taxpayer Advocate Service of the IRS, for a list of addresses and fax numbers.

How To Make a Contribution To Reduce the Public Debt

To make a contribution to reduce the public debt, send a check made payable to the "Bureau of the Public Debt" to Bureau of the Public Debt, Department G, P.O. Box 2188, Parkersburg, WV 26106-2188. Or, enclose a check with Form 1120S. Contributions to reduce the public debt are deductible, subject to the rules and limitations for charitable contributions.

How To Get Forms and Publications

Personal computer. You can access the IRS Web Site 24 hours a day, 7 days a week at www.irs.gov to:

- Download forms, instructions, and publications.
- See answers to frequently asked tax questions.
- Search publications on-line by topic or keyword.
- Send us comments or request help by e-mail.
- Sign up to receive local and national tax news by e-mail.

You can also reach us using file transfer protocol at [ftp.irs.gov](ftp://ftp.irs.gov).

CD-ROM. Order **Pub. 1796**, Federal Tax Products on CD-ROM, and get:

- Current year forms, instructions, and publications.
- Prior year forms, instructions, and publications.
- Frequently requested tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.
- The Internal Revenue Bulletin.

Buy the CD-ROM on the Internet at www.irs.gov/cdorders from the National Technical Information Service (NTIS) for \$21 (no handling fee) or call **1-877-CDFORMS** (1-877-233-6767) toll free to buy the CD-ROM for \$21 (plus a \$5 handling fee).

By phone and in person. You can order forms and publications 24 hours a day, 7 days a week, by calling **1-800-TAX-FORM** (1-800-829-3676). You can also get most forms and publications at your local IRS office.

General Instructions

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 for any tax year before the year the election takes effect.

Termination of Election

Once the election is made, it stays in effect until it is terminated. If the election is terminated in a tax year beginning after 1996, the corporation (or a successor corporation) can make another election on Form 2553 only with IRS consent for any tax year before the 5th tax year after the first tax year in which the termination took effect. 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 accumulated earnings and profits and **(b)** derives more than 25% of its gross receipts from passive investment income as defined in section 1362(d)(3)(C). 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 it 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, 2002. 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.

Private Delivery Services

In addition to the United States mail, the corporation can use certain private delivery services designated by the IRS to meet the "timely mailing as timely filing/paying" rule for tax returns and payments. The most recent list of designated private delivery services was published by the IRS in October 2001. The list includes only the following:

- Airborne Express (Airborne): Overnight Air Express Service, Next Afternoon Service, Second Day Service.
- DHL Worldwide Express (DHL): DHL "Same Day" Service, DHL USA Overnight.
- Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2Day.
- United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS

Worldwide Express Plus, UPS Worldwide Express.

The private delivery service can tell you how to get written proof of the mailing date.

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 2001 return for calendar year 2001 and fiscal years beginning in 2001 and ending in 2002. 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 2001 Form 1120S may also be used if (a) the corporation has a tax year of less than 12 months that begins and ends in 2002 and (b) the 2002 Form 1120S is not available by the time the corporation is required to file its return. However, the corporation must show its 2002 tax year on the 2001 Form 1120S and incorporate any tax law changes that are effective for tax years beginning after December 31, 2001.*

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 an officer or employee of the corporation completes Form 1120S, the paid preparer's space should remain blank. In addition, anyone who prepares Form 1120S, but does not charge the corporation, should not complete that section. Generally, anyone who is paid to prepare the return must sign it and fill in the "Paid Preparer's Use Only" area.

The paid preparer **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 the return to the taxpayer.

Paid Preparer Authorization

If the corporation wants to allow the IRS to discuss its 2001 tax return with the paid preparer who signed it, check the "Yes" box in the signature area of the return. This authorization applies only to the individual whose signature appears in the "Paid Preparer's Use Only" section of the return. It does not apply to the firm, if any, shown in that section.

If the "Yes" box is checked, the corporation is authorizing the IRS to call the paid preparer to answer any questions that may arise during the processing of its return. The corporation is also authorizing the paid preparer to:

- Give the IRS any information that is missing from its return,
- Call the IRS for information about the processing of its return or the status of its refund or payment(s), and

- Respond to certain IRS notices that the corporation has shared with the preparer about math errors, offsets, and return preparation. The notices will not be sent to the preparer.

The corporation is not authorizing the paid preparer to receive any refund check, bind the corporation to anything (including any additional tax liability), or otherwise represent the corporation before the IRS. If the corporation wants to expand the paid preparer's authorization, see **Pub. 947**, Practice Before the IRS and Power of Attorney.

The authorization cannot be revoked. However, the authorization will automatically end no later than the due date (excluding extensions) for filing the 2002 tax return.

Accounting Methods

Figure ordinary income using the method of accounting regularly used in keeping the corporation's books and records. Generally, permissible methods include:

- Cash,
- Accrual, or
- Any other method authorized by the Internal Revenue Code.

In all cases, the method used must clearly reflect income. Unless the corporation is a qualifying taxpayer, it must use the accrual method for sales and purchases of inventory items. See **Schedule A—Cost of Goods Sold** on page 16 for the definition of a qualifying taxpayer.

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, which is the earliest of the date (a) the required performance takes place, (b) payment is due, or (c) payment is received, 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 certain items, including recurring expenses. See section 461(h) and the related regulations for the rules for determining when economic performance takes place.

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. For rules on long-term contracts,

Where To File

File your return at the applicable IRS address listed below.

If the corporation's principal business, office, or agency is located in:	And the total assets at the end of the tax year (Form 1120S, page 1, item E) are:	Use the following Internal Revenue Service Center address:
Connecticut, Delaware, District of Columbia, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, West Virginia, Wisconsin	Less than \$10 million	Cincinnati, OH 45999-0013
	\$10 million or more	Ogden, UT 84201-0013
Alabama, Alaska, Arizona, Arkansas, California, Colorado, Florida, Georgia, Hawaii, Idaho, Iowa, Kansas, Louisiana, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Tennessee, Texas, Utah, Washington, Wyoming	Any amount	Ogden, UT 84201-0013
A foreign country or U.S. possession	Any amount	Philadelphia, PA 19255-0013

see section 460 and the underlying regulations.

Mark-to-Market Accounting Method

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 and the related regulations.

Dealers in commodities and traders in securities and commodities may elect to use the mark-to-market accounting method. To make the election, the corporation must file a statement describing the election, the first tax year the election is to be effective, and, in the case of an election for traders in securities or commodities, the trade or business for which the election is made. Except for new taxpayers, the statement must be filed by the due date (not including extensions) of the income tax return for the tax year immediately **preceding** the election year and attached to that return, or, if applicable, to a request for an extension of time to file that return. For more details, see Rev. Proc. 99-17, 1999-1 C.B. 503, and sections 475(e) and (f).

Change in Accounting Method

Generally, the corporation must get IRS consent to change its method of accounting used to report taxable income (for income as a whole or for any material item). To do so, it must file **Form 3115**, Application for Change in Accounting Method. For more information, see **Pub. 538**, Accounting Periods and Methods.

In changing its method of accounting, the corporation may also have to make an adjustment to prevent amounts of income or expense from being duplicated or omitted. This is called a section 481(a) adjustment, which is taken into account over a period not to exceed 4 years. For example, if the corporation changes to the cash method of accounting and chooses not to account for inventories, and it accrued sales in 2000 for which it received payment in 2001, it must report those sales in both years as a result of changing its accounting method and must make a section 481(a) adjustment to prevent duplication of income. See Rev. Proc. 99-49, 1999-2 C.B. 725, to figure the amount of this adjustment for the tax year. Include any positive section 481(a) adjustment on page 1, line 5. If the section 481(a) adjustment is negative, report it on page 1, line 19.

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 the shorter of 3 months or the deferral period of the tax year being changed. 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 is penalized for willfully failing 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. Usually, records that support an item of income, deduction, or credit on the corporation's return 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.

Depository 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. The two methods of depositing corporate income taxes are discussed below.

Electronic Deposit Requirement

The corporation must make electronic deposits of **all** depository taxes (such as employment tax, excise tax, and corporate income tax) using the Electronic Federal Tax Payment System (EFTPS) in 2002 if:

- The total deposits of such taxes in 2000 were more than \$200,000 or
- The corporation was required to use EFTPS in 2001.

If the corporation is required to use EFTPS and fails to do so, it may be subject to a 10% penalty. If the corporation is not required to use EFTPS, it may participate voluntarily. To enroll in or get more information about EFTPS, call 1-800-555-4477 or 1-800-945-8400. To enrol online, visit www.eftps.gov.

Depositing on time. For EFTPS deposits to be made timely, the corporation must initiate the transaction at least 1 business day before the date the deposit is due.

Deposits With Form 8109

If the corporation does not use EFTPS, deposit corporation income tax payments (and estimated tax payments) with **Form 8109**, Federal Tax Deposit Coupon. If you do not have a preprinted Form 8109, use Form 8109-B to make deposits. You can get this form **only** by calling 1-800-829-1040. Be sure to have your employer identification number (EIN) ready when you call.

Do not send 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 an authorized depository, i.e., a commercial bank or other financial institution authorized to accept Federal tax deposits.

Make checks or money orders payable to the depository. To help ensure proper crediting, write the corporation's EIN, the tax period to which the deposit applies, and "Form 1120S" on the check or money order. Be sure to darken the "1120" box on the coupon. Records of these deposits will be sent to the IRS.

If the corporation prefers, it may mail the coupon and payment to: Financial Agent, Federal Tax Deposit Processing, P.O. Box 970030, St. Louis, MO 63197. Make the check or money order payable to "Financial Agent."

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 smaller 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 2002 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 depository method described on page 4.

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 1/2 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.

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.

Other Forms, Returns, and Statements That May Be Required

- **Schedule N** (Form 1120), Foreign Operations of U.S. Corporations. The corporation may have to file this schedule if it had assets in or operated a business in a foreign country or a U.S. possession.
- **Forms W-2** and **W-3**, Wage and Tax Statement; and Transmittal of Wage and

Tax Statements. Use these forms to report wages, tips, other compensation, withheld income taxes, and withheld social security/Medicare taxes for employees.

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



See **Trust Fund Recovery Penalty** above.

- **Form 926**, Return by a U.S. Transferor of Property to a Foreign Corporation. Use this form to report certain information required under section 6038B.
- **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.



See **Trust Fund Recovery Penalty** above.

- **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.



See **Trust Fund Recovery Penalty** above.

- **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 Entities.

- **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 (including points) in the course of the corporation's trade or business.
- **Forms 1099-A, B, C, DIV, INT, LTC, MISC, MSA, OID, PATR, R, and S**. You may have to file these information returns to report acquisitions or abandonments of secured property; proceeds from broker and barter exchange transactions; cancellation of debt; certain dividends and distributions; interest payments; payments of long-term care and accelerated death benefits; miscellaneous income payments; distributions from an Archer MSA or Medicare+Choice MSA; original issue discount; distributions from cooperatives to their patrons; 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 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 3520**, Annual Return to Report Transactions With Foreign Trust and Receipt of Certain Foreign Gifts. The corporation may have to file this form if it:

1. Directly or indirectly transferred property or money to a foreign trust. For this purpose, any U.S. person who created a foreign trust is considered a transferor.
2. Is treated as the owner of any part of the assets of a foreign trust under the grantor trust rules.
3. Received a distribution from a foreign trust.

For more information, see the Instructions for Form 3520.

Note: *An owner of a foreign trust must ensure that the trust files an annual information return on Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner.*

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

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 owns stock in a corporation that is 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.

- **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 to report those operations and figure the loss of certain tax 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 Allocation Statement Under Sections 338 and 1060. Both the seller and buyer of a group of assets that makes up a trade or business must use this form to report such a sale if goodwill or going concern value attaches, or could attach, to such assets and if the buyer'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 25 for line 23, item 10, of Schedule K-1 for details on the Form 8697 information they must provide to their shareholders.

- **Form 8865**, Return of U.S. Person With Respect to Certain Foreign Partnerships. A corporation may have to file Form 8865 if it:

1. Controlled a foreign partnership (i.e., owned more than a 50% direct or indirect interest in the partnership).
2. Owned at least a 10% direct or indirect interest in a foreign partnership while U.S. persons controlled that partnership.
3. Had an acquisition, disposition, or change in proportional interest of a foreign partnership that:
 - a. Increased its direct interest to at least 10% or reduced its direct interest of at least 10% to less than 10%.
 - b. Changed its direct interest by at least a 10% interest.
4. Contributed property to a foreign partnership in exchange for a partnership interest if:

- a. Immediately after the contribution, the corporation owned, directly or indirectly, at least a 10% interest in the foreign partnership; or
- b. The fair market value of the property the corporation contributed to the foreign partnership in exchange for a partnership interest, when added to other contributions of property made to the foreign partnership during the preceding 12-month period, exceeds \$100,000.

Also, the corporation may have to file Form 8865 to report certain dispositions by a foreign partnership of property it

previously contributed to that foreign partnership if it was a partner at the time of the disposition.

For more details, including penalties for failing to file Form 8865, see Form 8865 and its separate instructions.

• **Form 8866**, Interest Computation Under the Look-Back Method for Property Depreciated Under the Income Forecast Method. Certain S corporations that are not closely held may have to file Form 8866. Form 8866 is used to figure the interest due or to be refunded under the look-back method of section 167(g)(2) for certain property placed in service after September 13, 1995, and depreciated under the income forecast method.

Closely held corporations should see the instructions on page 26 for line 23, item 17, of Schedule K-1 for details on the Form 8866 information they must provide to their shareholders.

• **Form 8873**, Extraterritorial Income Exclusion. Use this form to report the amount of extraterritorial income excluded from the corporation's gross income for the tax year.

Statements

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).

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.

Assembling the Return

To ensure that the corporation's tax return is correctly processed, attach all schedules and forms after page 4, Form 1120S, in the following order:

1. Schedule N (Form 1120).
2. **Form 4136**, Credit for Federal Tax Paid on Fuels.
3. Form 8050.
4. Additional schedules in alphabetical order.
5. Additional forms in numerical order.

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 and place them at the end of the return. Use the same size and format as on the printed forms. **But show the totals on the printed forms.** Be sure to put the

corporation's name and 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(5). 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.

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 7 through 10) and the instructions for Schedules K and K-1 (pages 18 through 26) 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 8) even if the shareholder materially participates. For exceptions, see **Activities That Are Not Passive Activities** below. 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 9); 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 if the shareholder 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 conditions **2a** and **b** above, 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. For purposes of this rule, personal property means property that is actively traded, such as stocks, bonds, and other securities. 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 does not apply to an S corporation because state law generally limits the liability of 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 10 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 any of the following apply:

- The **average period of customer use** (defined below) for such property is 7 days or less.
- 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.
- **Extraordinary personal services** (defined below) are provided by or on behalf of the corporation.
- 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).
- The corporation customarily makes the property available during defined

business hours for nonexclusive use by various customers.

- 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. 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.

In addition, a guaranteed payment described in section 707(c) is not income from a rental activity under any 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. To determine if 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:

- Services necessary to permit the lawful use of the rental property.
- 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.
- 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. Examples include 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 of property is **incidental** to an **activity of holding property for investment** if both of the following apply:

- The main purpose for holding the property is to realize a gain from the appreciation of the property.
- 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 of property is **incidental** to a **trade or business activity** if all of the following apply:

- The corporation owns an interest in the trade or business at all times during the year.
- 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.
- 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:

- Interest income on loans and investments made in the ordinary course of a trade or business of lending money.
- 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.
- 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.
- 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).
- Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property.
- 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.
- 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 deductions 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,
- Activities conducted directly by the corporation, or
- 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 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. Net rental activity income is nonpassive income for a shareholder if all of the following apply:

- The corporation recognizes gain from the sale, exchange, or other disposition of the rental property during the tax year.
- 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 (a) the corporation owns an interest in the property, (b) substantially all of the property is either rented or held out for rent and ready to be rented, and (c) no significant value-enhancing services remain to be performed.
- The shareholder materially participated or significantly participated for any tax year in an activity that involved the performing of services to enhance 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).

Because the corporation cannot determine a shareholder's level of participation, the corporation must identify net income from property described above (without regard to the shareholder's level of participation) 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 in item 4) 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.

Extraterritorial Income Exclusion

The corporation may exclude extraterritorial income to the extent of qualifying foreign trade income. For details and to figure the amount of the exclusion, see Form 8873 and its separate instructions. The corporation must report the extraterritorial income exclusion on its return as follows:

1. If the corporation met the foreign economic process requirements explained in the Instructions for Form 8873, it may report the exclusion as a non-separately stated item on whichever of the following lines apply to that activity:

- Form 1120S, page 1, line 19;
- Form 8825, line 15; or
- Form 1120S, Schedule K, line 3b.

In addition, the corporation must report as an item of information on Schedule K-1, line 23, the shareholder's pro rata share of foreign trading gross receipts from Form 8873, line 15.

2. If the foreign trading gross receipts of the corporation for the tax year are \$5 million or less and the corporation did not meet the foreign economic process requirements, it may not report the extraterritorial income exclusion as a non-separately stated item on its return. Instead, it must report the following separately-stated items to the shareholders on Schedule K-1, line 23:

- The shareholder's pro rata share of foreign trading gross receipts from Form 8873, line 15.
- The shareholder's pro rata share of the extraterritorial income exclusion from Form 8873, line 55, and identify the activity to which the exclusion relates.

Note: Upon request of a shareholder, the corporation should furnish a copy of the corporation's Form 8873 if that shareholder has a reduction for international boycott operations, illegal bribes, kickbacks, etc.

Specific Instructions

General Information

Name, Address, and Employer Identification Number

Use the label 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, 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.

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

Item B—Business Code No.

See the **Codes for Principal Business Activity** on pages 29 through 31 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. If the S election terminated during the tax year, see the instructions for Schedule L on page 26 for special rules that may apply when figuring the corporation's year-end assets.

Item F—Initial Return, Final Return, Name Change, Address Change, 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.

If the corporation changed its name since it last filed a return, check box F(3). Generally, a corporation cannot change its name unless it amended its articles of incorporation and files the amendment with the state in which it is incorporated.

Indicate a change in address by checking box F(4). If a change in address occurs after the return is filed, use **Form 8822**, Change of Address, to notify the IRS of the new address.

If this amends a previously filed return, check box F(5). If Schedules K-1 are also being amended, check box D(2) on each Schedule K-1.

Income



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 **Passive Activity Limitations** beginning on page 7 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).

Tax-exempt income. 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 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** beginning on page 12 for information on how to report expenses related to tax-exempt income.

Cancelled debt exclusion. 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**, Bankruptcy Tax Guide.

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. In general, advance payments are reported in the year of receipt. To report income from long-term contracts, see section 460. For special rules for reporting certain advance payments for goods and long-term contracts, see Regulations section 1.451-5. For permissible methods for reporting certain advance payments for services by an accrual method corporation, see Rev. Proc. 71-21, 1971-2 C.B. 549.

Installment sales. Generally, the installment method cannot be used for dealer dispositions of property. A "dealer disposition" is any disposition of (a) personal property by a person who regularly sells or otherwise disposes of property of the same type on the installment plan or (b) real property held for sale to customers in the ordinary course of the taxpayer's trade or business.

Exception. These restrictions on using the installment method do not apply to dispositions of property used or produced in a farming business or sales of timeshares and residential lots for which the corporation elects to pay interest under section 453(l)(3).

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:

- Gross sales.
- Cost of goods sold.
- Gross profits.
- Percentage of gross profits to gross sales.
- Amount collected.
- Gross profit on the amount collected.

Line 2—Cost of Goods Sold

See the instructions for Schedule A on page 16.

Line 4—Net Gain (Loss) From Form 4797



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 25 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:

- Interest income derived in the ordinary course of the corporation's trade or business, such as interest charged on receivable balances.
- Recoveries of bad debts deducted in earlier years under the specific charge-off method.
- Taxable income from insurance proceeds.
- The amount of credit figured on **Form 6478**, Credit for Alcohol Used as Fuel.

The corporation must also include in other income the:

- Recapture amount under 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.
- Recapture of any deduction previously taken under section 179A. The S corporation may have to recapture part or all of the benefit of any allowable deduction for qualified clean-fuel vehicle property (or clean-fuel vehicle refueling property), if the property ceases to qualify for the deduction within 3 years after the date it was placed in service. See **Pub. 535**, Business Expenses, for details on how to figure the recapture.

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.

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 18.

Ordinary Income (Loss) From a Partnership, Estate, or Trust

Enter the ordinary trade or business income (loss) from a partnership shown on Schedule K-1 (Form 1065), from an estate or trust shown on Schedule K-1 (Form 1041), or from a foreign partnership, estate, or trust. Show the partnership's, estate's, or trust's name, address, and EIN (if any) on a separate statement attached to this return. If the amount entered is from more than one source, identify the amount from each source.

Do not include portfolio income or rental activity income (loss) from a partnership, estate, or trust on this line. Instead, report these amounts on the applicable lines of Schedules K and K-1, or on line 20a of Form 8825 if the amount is from a rental real estate activity.

Ordinary income or loss from a partnership that is a publicly traded partnership is not reported on this line. Instead, report the amount separately on line 6 of Schedules K and K-1.

Treat shares of other items separately reported on Schedule K-1 issued by the other entity as if the items were realized or incurred by the S corporation.

If there is a loss from a partnership, the amount of the loss that may be claimed is subject to the at-risk and basis limitations as appropriate.

If the tax year of the S corporation does not coincide with the tax year of the partnership, estate, or trust, include the ordinary income (loss) from the other entity in the tax year in which the other entity's tax year ends.

Deductions



*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 7 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 costs certain costs incurred in connection with:

- The production of real and tangible personal property held in inventory or held for sale in the ordinary course of business.

- Real property or personal property (tangible and intangible) acquired for resale.
- The production of real property and tangible personal property by a corporation for use in its trade or business or in an activity engaged in for profit.

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.

Exceptions. 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.
- Timber.
- Most property produced under a long-term contract.
- Certain property produced in a farming business. See page 13.

The corporation must report the following costs separately to the shareholders for purposes of determinations under section 59(e):

- Research and experimental costs under section 174.
- Intangible drilling costs for oil, gas, and geothermal property.
- Mining exploration and development costs.
- Inventory of a corporation that accounts for inventories in the same manner as materials and supplies that are not incidental. See **Cost of Goods Sold** on page 16.

Tangible personal property

produced by a corporation includes a film, sound recording, video tape, book, or similar property.

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 or are incurred by reason of the performance of production or resale activities.

For 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.
- Contributions to pension, stock bonus, and certain profit-sharing, annuity, or deferred compensation plans.

Regulations section 1.263A-1(e)(3) specifies other indirect costs that relate to production or resale activities that must be capitalized and those that may be currently deducted.

Interest expense paid or incurred during the production period of designated property must be capitalized and is governed by special rules. For more details, see Regulations sections 1.263A-8 through 1.263A-15.

For more details on the uniform capitalization rules, 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—

- Animal or
- 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 each shareholder makes the election to deduct these expenses, the corporation should not capitalize them. Instead, the corporation should report the expenses separately on line 21 of Schedule K and each shareholder's pro rata share on line 23 of Schedule K-1.

See sections 263A(d) and (e) and Regulations section 1.263A-4 for definitions and other details.

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 and Regulations section 1.195-1.

Reducing certain expenses for which credits are allowable. For each credit 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 work opportunity credit,
2. The welfare-to-work credit,
3. The credit for increasing research activities,
4. The enhanced oil recovery credit,

5. The disabled access credit,
6. The empowerment zone employment credit,
7. The Indian employment credit,
8. The credit for employer social security and Medicare taxes paid on certain employee tips, and
9. The orphan drug credit.

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 and Line 8—Salaries and Wages

Enter on line 7 the total compensation of all officers paid or incurred in the trade or business activities of the corporation. Enter on line 8 the amount of salaries and wages paid or incurred to employees (other than officers) during the tax year in the trade or business activities of the corporation.

Reduce the amounts on lines 7 and 8 by any applicable employment credits from **Form 5884**, Work Opportunity Credit, **Form 8861**, Welfare-to-Work 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 officers and employees 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 amounts paid or incurred for fringe benefits of officers and 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. For 2001, a more than 2% shareholder may be allowed to deduct up to 60% of such amounts on Form 1040, line 28.

Do not include amounts reported elsewhere on the return, such as salaries and wages 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 or a SIMPLE IRA plan.


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).

 *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 12/31/98	\$15,500
After 12/31/96 but before 1/1/99	\$15,800
After 12/31/94 but before 1/1/97	\$15,500
After 12/31/93 but before 1/1/95	\$14,600

If the lease term began before January 1, 1994, see **Pub. 463**, Travel, Entertainment, Gift, and Car Expenses, to find out if the corporation has an inclusion amount.

See Pub. 463 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 the following taxes on line 12:

- State and local sales taxes paid or incurred 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.

- 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.
- Section 901 foreign taxes. Report these taxes separately on line 15g, Schedule K.
- Taxes allocable 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. Report these taxes separately on line 9 of Schedules K and K-1.
- 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.
- Clearly and directly allocable to portfolio or investment income. This interest expense is reported separately on line 11a of Schedule K.
- 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.
- On debt required to be allocated to the production of designated property. Interest allocable to designated property produced by an S corporation for its own use or for sale must instead be capitalized. The corporation must also capitalize any interest on debt allocable to an asset used to produce designated 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 on an attachment for line 23 of Schedule K-1. See section 263A(f) and Regulations sections 1.263A-8 through 1.263A-15 for additional information, including the definition of "designated property."

Special rules apply to:

- 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. Temporary Regulations section 1.163-8T gives rules for tracing debt proceeds to expenditures.
- Prepaid interest, which generally can only be deducted over the period to which the prepayment applies. See section 461(g) for details.
- Limit the interest deduction if the corporation is a policyholder or beneficiary with respect to a life insurance, endowment, or annuity contract issued after June 8, 1997. For details, see section 264(f). Attach a statement showing the computation of the deduction.

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 the tax year 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.



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 25 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) or

SIMPLE 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 the applicable form listed below.

- **Form 5500**, Annual Return/Report of Employee Benefit Plan. File this form for a plan that is not a one-participant plan (see below).
- **Form 5500-EZ**, Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan. File this form for a plan that only covers the owner (or the owner and his or her spouse) but only if the owner (or the owner and his or her spouse) owns the entire business.

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)** employer contributions to certain accident and health plans, **(b)** the cost of up to \$50,000 of group-term life insurance on an employee's life, and **(c)** 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 **only** for which there is no separate line on page 1 of Form 1120S. Enter the total on this line. Examples of other deductions include:

- Amortization (except as noted below)—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 the tax year.
- Insurance premiums.
- Legal and professional fees.

- Supplies used and consumed in the business.
- Utilities.

Also, see **Special Rules** below for limits on certain other deductions.

Do not deduct on line 19:

- Items that must be reported separately on Schedules K and K-1.
- Qualified expenditures to which an election under section 59(e) may apply. See the instructions on page 24 for lines 16a and 16b of Schedule K-1 for details on treatment of these items.
- Amortization of reforestation expenditures under section 194. The corporation can elect to amortize up to \$10,000 of qualified reforestation expenditures paid or incurred during the tax year. However, the amortization is not deducted by the corporation but the amortizable basis is instead separately allocated among the shareholders. See the instructions on page 26 for Schedule K-1, line 23, item 18 and Pub. 535 for more details.
- Fines or penalties paid to a government for violating any law. Report these expenses on Schedule K, line 19.
- Expenses allocable to tax-exempt income. Report these expenses on Schedule K, line 19.
- Net operating losses as provided by section 172 or the special deductions in sections 241 through 249 (except the election to amortize organizational expenditures under section 248). These deductions cannot be claimed by an S corporation.

Note: Shareholders are allowed, subject to limitations, to deduct from gross income the corporation's net operating loss. See section 1366.

Special Rules

Travel, meals, and entertainment.

Subject to limitations and restrictions discussed below, a corporation can deduct ordinary and necessary travel, meals, and entertainment expenses paid or incurred in its trade or business. Special rules apply to deductions for gifts, skybox rentals, luxury water travel, convention expenses, and entertainment tickets. See section 274 and Pub. 463 for more details.

Travel. The corporation cannot deduct travel expenses of any individual accompanying a corporate officer or employee, including a spouse or dependent of the officer or employee, unless:

- That individual is an employee of the corporation, and
- His or her travel is for a bona fide business purpose and would otherwise be deductible by that individual.

Meals and entertainment. Generally, the corporation can deduct only 50% of the amount otherwise allowable for meals and entertainment expenses. In addition (subject to exceptions under section 274(k)(2)):

- 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(n)(3) for a special rule that applies to expenses for meals consumed by individuals subject to the hours of service limits of the Department of Transportation.

Membership dues. The corporation may deduct amounts paid or incurred for membership dues in 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. However, no deduction is allowed if a principal purpose of the organization is to entertain, or provide entertainment facilities for, members or their guests. In addition, corporations may not deduct 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.

Entertainment facilities. The corporation 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.

Lobbying expenses. 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.

Clean-fuel vehicles and certain refueling property. A deduction is allowed for part of the cost of qualified clean-fuel vehicle property and qualified clean-fuel vehicle refueling property placed in service during the tax year. For more details, see section 179A and Pub. 535.

Certain corporations engaged in farming. 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, see **Pub. 225**, Farmer's Tax Guide.

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 accumulated earnings and profits (E&P) 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 on page 16 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 on page 16 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 21 of Part III and line 27 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.

To the left of the line 22c total, enter the amount of recapture tax and "Tax From Form 4255." 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 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. To the left of the total on line 22c, enter the installment amount and "LIFO tax."

Interest due under the look-back method for completed long-term contracts.

If the corporation owes interest, attach **Form 8697**, Interest Computation Under the Look-Back Method for Completed Long-Term Contracts. To the left of the total on line 22c, enter the amount owed and "From Form 8697."

Interest due under the look-back method for property depreciated under the income forecast method.

If the corporation owes interest, attach **Form 8866**, Interest Computation Under the Look-Back Method for Property Depreciated Under the Income Forecast Method. To the left of the total on line 22c, enter the amount owed and "From Form 8866."

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, enter "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.

Line 27

If the corporation wants its refund directly deposited into its account at any U.S. bank or other financial institution instead of having a check sent to the corporation, complete Form 8050 and attach it to the corporation's return. However, the corporation cannot have its refund from an amended return directly deposited.

Schedule A—Cost of Goods Sold

Generally, 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.

However, if a corporation is a qualifying taxpayer, it may adopt or change its accounting method to account for inventory items in the same manner as materials and supplies that are not incidental. A **qualifying taxpayer** is a taxpayer (a) whose average annual gross receipts for the 3 prior tax years are \$1 million or less and (b) whose business is not a tax shelter (as defined in section 448(d)(3)). Under this accounting method, inventory costs for raw materials purchased for use in producing finished goods and merchandise purchased for resale are deductible in the year the finished goods or merchandise are sold (but not before the year the corporation paid for the raw materials or merchandise if it is also using the cash method). Enter amounts paid for all raw materials and merchandise during the tax year on line 2. The amount the corporation can deduct for the tax year is figured on line 8. For additional guidance on this method of accounting for inventory items, see Rev. Proc. 2001-10, 2001-2 I.R.B. 272.

Section 263A Uniform Capitalization Rules

The uniform capitalization rules of section 263A are discussed under **Limitations on Deductions** on page 12. See those instructions before completing Schedule A.

Worksheet for Line 22a

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

*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.

Line 1—Inventory at Beginning of Year

If the corporation is changing its method of accounting for the current tax year to no longer account for inventories, it must refigure last year's closing inventory using the new method of accounting and enter the result on line 1. If there is a difference between last year's closing inventory and the refigured amount, attach an explanation and take it into account when figuring the corporation's section 481(a) adjustment (explained on page 4).

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, such as processing, assembly, repackaging, and transporting; 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 includable 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.

If the corporation accounts for inventories in the same manner as materials and supplies that are not incidental, enter on line 7 the portion of its raw materials and merchandise purchased for resale that are included on line 6 and were not sold during the year.

Lines 9a Through 9e—Inventory Valuation Methods

Inventories can be valued at:

- Cost.
- Cost or market value (whichever is lower).
- Any other method approved by the IRS that conforms to the requirements of the applicable regulations.

However, the corporation is required to use cost if it chooses to account for inventory items in the same manner as materials and supplies that are not incidental.

Producers whose average annual gross receipts are \$1 million or less that account for inventories in the same manner as materials and supplies that are not incidental may currently deduct expenditures for direct labor and all indirect costs that would otherwise be included in inventory costs.

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 8.

Line 7

Complete line 7 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 7 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 8

Check the box on line 8 if the corporation was a C corporation in a prior year and has accumulated earnings and profits (E&P) at the close of its 2001 tax year. For details on figuring accumulated E&P, see section 312. If the corporation has accumulated 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.

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, 22b, and 22c, 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,

W:CAR:MP:FP:S:SP, 1111 Constitution Avenue, NW, 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. 2001-45, 2001-37 I.R.B. 227.

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.

A shareholder who disposes of stock is treated as the shareholder for the day of disposition. A shareholder who dies is treated as the shareholder for the day of the shareholder's death.

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 affected 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 separate 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 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 section 1377(a)(2) and Regulations section 1.1377-1(b) to treat the tax year as if it consisted of 2 separate tax years. The statement must also explain how the shareholder's entire interest was terminated (e.g., sale or gift), and state that the corporation and each affected shareholder consent to the corporation making the election. A corporate officer must sign the statement under penalties of perjury on behalf of the corporation. A single statement may be filed for all terminating elections made for the tax year. If the election is made, write "Section 1377(a)(2) Election Made" at the top of each affected shareholder's Schedule K-1.

For more details on the election, see Regulations section 1.1377-1(b).

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 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 10 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 18 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 or has invested in a registration-required tax shelter, it must enter its tax shelter registration number in item C. Also, a corporation that has invested in a registration-required shelter must furnish a copy of its Form 8271 to its shareholders. See Form 8271 for more details.

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 33).** 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 25).** 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 section 1362(d)(3)(C)) 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 10 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** on this page.

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 10 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** on this page.

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 those reported on Form 8825. If the corporation has more than one rental activity reported on line 3, see **Passive Activity Reporting Requirements** on page 10 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 this page. Also see **Rental activities** on page 8 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 9 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 ordinary 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, 4e(1), 4e(2), and 4e(3). Enter on line 4d the gain or loss that is portfolio income (loss) from Schedule D (Form 1120S), line 6. Enter on line 4e(1) the gain or loss that is portfolio income (loss)

from Schedule D (Form 1120S), line 14. Enter on line 4e(2) the gain or loss that is portfolio income (loss) from Schedule D (Form 1120S), line 13. Enter on line 4e(3) the gains (not losses) from the disposition of assets (excluding property that could qualify for section 1202 gain) held more than 5 years that is portfolio income included on Schedule D (Form 1120S), line 14.

If any gain or loss from lines 6, 13, and 14 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(1) through 4e(3). Instead, report it on line 6 of Schedules K and K-1. If the corporation had a gain from such property held more than 5 years, show the total of all such gains on an attachment to Schedule K-1. Indicate on the statement that the shareholder should include this amount on line 4 of the worksheet for line 29 of Schedule D (Form 1040). 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 Section 1231 Gain (Loss) (Other Than Due to Casualty or Theft)

Enter the net section 1231 gain (loss) (excluding net gain from involuntary conversions due to casualty or theft) from Form 4797, line 7. If the corporation had a gain from any section 1231 property held more than 5 years, show the total of all such gains on an attachment to Schedule K-1; do not include any gain attributable to straight-line depreciation from section 1250 property. Indicate on the statement that this amount should be included in the shareholder's computation of qualified 5-year gain only if the amount on the shareholder's Form 4797, line 7, is more than zero.

Report net gain or loss from involuntary conversions due to casualty or theft 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 10 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 19.

Line 6—Other Income (Loss)

Enter any other item of income or loss not included on lines 1 through 5. Items to be reported on line 6 include:

- Recoveries of tax benefit items (section 111).
- Gambling gains and losses (section 165(d)).
- Gains from the disposition of an interest in oil, gas, geothermal, or other mineral properties (section 1254).
- 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.
- Any net gain or loss from section 1256 contracts from **Form 6781**, Gains and Losses From Section 1256 Contracts and Straddles.
- Gain from the sale or exchange of qualified small business stock (as defined in the Instructions for Schedule D) that is eligible for the 50% section 1202 exclusion. To be eligible for the section 1202 exclusion, the stock must have been held by the corporation for more than 5 years. Corporate shareholders are not eligible for the section 1202 exclusion. Additional limitations apply at the shareholder level. Report each shareholder's share of section 1202 gain on Schedule K-1. Each shareholder will determine if he or she qualifies for the section 1202 exclusion. Report on an attachment to Schedule K-1 for each sale or exchange the name of the qualified small business that issued the stock, the shareholder's share of the corporation's adjusted basis and sales price of the stock, and the dates the stock was bought and sold.
- Gain eligible for section 1045 rollover (replacement stock purchased by the corporation). Include only gain from the sale or exchange of qualified small business stock (as defined in the Instructions for Schedule D) that was deferred by the corporation under section 1045 and reported on Schedule D. See the Instructions for Schedule D for more details. Corporate shareholders are not eligible for the section 1045 rollover. Additional limitations apply at the shareholder level. Report each shareholder's share of the gain eligible for section 1045 rollover on Schedule K-1. Each shareholder will determine if he or she qualifies for the rollover. Report on an attachment to Schedule K-1 for each sale or exchange the name of the qualified small business that issued the stock, the shareholder's share of the corporation's adjusted basis and sales price of the stock, and the dates the stock was bought and sold.
- Gain eligible for section 1045 rollover (replacement stock not purchased by the corporation). Include only gain from the


sale or exchange of qualified small business stock (as defined in the Instructions for Schedule D) the corporation held for more than 6 months but that **was not** deferred by the corporation under section 1045. See the Instructions for Schedule D for more details. A shareholder (other than a corporation) may be eligible to defer his or her pro rata share of this gain under section 1045 if he or she purchases other qualified small business stock during the 60-day period that began on the date the stock was sold by the corporation. Additional limitations apply at the shareholder level. Report on an attachment to Schedule K-1 for each sale or exchange the name of the qualified small business that issued the stock, the shareholder's share of the corporation's adjusted basis and sales price of the stock, and the dates the stock was bought and sold.

If the corporation is involved in more than one trade or business or rental activity, see **Passive Activity Reporting Requirements** on page 10 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 19.

Deductions

Line 7—Charitable Contributions

Enter the amount of charitable contributions paid during the 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. For additional information, see **Pub. 526**, Charitable Contributions.

 *An accrual basis S corporation may not elect to treat a contribution as having been paid in the tax year the board of directors authorizes the payment if the contribution is not actually paid until the next tax year.*

Generally, no deduction is allowed for any contribution of \$250 or more unless the corporation obtains a written acknowledgment 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 15g. 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.
- Contributions to a capital construction fund.
- 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 10. However, **do not attach Form 3800**, General Business Credit, to Form 1120S.*

Requirements on page 10. However, **do not attach Form 3800**, General Business Credit, to Form 1120S.

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 12a(1) of Schedule K-1 (Form 1065).

Line 12b(2). Report on line 12b(2) any low-income housing credit not reported on line 12b(1). This includes any credit from a partnership reported to the corporation on line 12a(2) of Schedule K-1 (Form 1065).

Note: *If part or all of the credit reported on line 12b(1) or 12b(2) is attributable to additions to qualified basis of property placed in service before 1990, report on an attachment to Schedules K and K-1 the amount of the credit on each line that is attributable to property placed in service (a) before 1990 and (b) 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 follow.

- Credit for backup withholding on dividends, interest, or patronage dividends.
- 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.
- Qualified electric vehicle credit (Form 8834).
- 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.
- Work opportunity credit (Form 5884).
- Welfare-to-work credit (Form 8861).
- Credit for increasing research activities (Form 6765).
- Enhanced oil recovery credit (Form 8830).
- Disabled access credit (Form 8826).
- 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).
- Orphan drug credit (Form 8820).
- New markets credit (Form 8874).
- Credit for contributions to selected community development corporations (Form 8847).
- General credits from an electing large partnership.

See the instructions on page 25 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 for the alternative minimum tax (AMT). See **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)), property depreciated under the unit-of-production method (or any other method not expressed in a term of years), or qualified Indian reservation property.

For property placed in service **before 1999**, refigure depreciation for the AMT as follows (using the same convention used for the regular tax):

- For section 1250 property (generally, residential rental and nonresidential real property), use the straight line method over 40 years.
- For tangible property (other than section 1250 property) depreciated using the straight line method for the regular tax, use the straight line method over the property's class life. Use 12 years if the property has no class life.
- For any other tangible property, use the 150% declining balance method, switching to the straight line method the first tax year it gives a larger deduction, over the property's AMT class life. Use 12 years if the property has no class life.

Note: See *Pub. 946* for a table of class lives.

For property placed in service **after 1998**, refigure depreciation for the AMT **only** for property depreciated for the regular tax using the 200% declining balance method. For the AMT, use the 150% declining balance method, switching to the straight line method the first tax year it gives a larger deduction, and the same convention and recovery period used for the regular tax.

Figure the adjustment by subtracting the AMT deduction for depreciation from the regular tax deduction and enter the result on line 14a. If the AMT deduction is more than the regular tax deduction, enter the difference as a negative amount. Depreciation capitalized to inventory must also be refigured using the AMT rules. Include on this line the current year adjustment to income, if any, resulting from the difference.

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 the AMT. The property's adjusted basis for the AMT is its cost or other basis minus all depreciation or amortization

deductions allowed or allowable for the AMT during the current tax year and previous tax years. Enter on this line the difference between the regular tax gain (loss) and the AMT gain (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.

If any part of the adjustment is allocable to net short-term capital gain (loss), net long-term capital gain (loss), or net section 1231 gain (loss), attach a schedule that identifies the amount of the adjustment allocable to each type of gain or loss. For a net long-term capital gain (loss), also identify the amount of the adjustment that is 28% rate gain (loss). For a net section 1231 gain (loss), also identify the amount of adjustment that is unreaptured section 1250 gain.

No schedule is required if the adjustment is allocable solely to ordinary gain (loss).

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 and preference items separately under section 613A.

Refigure the depletion deduction under section 611 for mines, wells (other than oil and gas wells), and other natural deposits for the AMT. Percentage depletion is limited to 50% of the taxable income from the property as figured under section 613(a), using only income and deductions for the AMT. Also, the deduction is limited to the property's adjusted basis at the end of the year, as refigured for the AMT. Figure this limit separately for each property. When refiguring the property's adjusted basis, take into account any AMT adjustments made this year or in previous years that affect basis (other than the current year's depletion).

Enter the difference between the regular tax and AMT deduction. If the AMT deduction is greater, enter the difference as a negative amount.

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 pass-through 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 that 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 allowed for the AMT that are allocable to oil, gas, and geothermal properties.

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 the AMT.
- Losses from tax shelter farm activities. No loss from any tax shelter farm activity is allowed for the AMT.

Foreign Taxes

Lines 15a through 15h must be completed if the corporation has foreign income, deductions, or losses, or has paid or accrued foreign taxes. See **Pub. 514**, Foreign Tax Credit for Individuals, for more information.

Line 15a—Name of Foreign Country or U.S. Possession

Enter the name of the foreign country or U.S. possession from which the corporation had income or to which the corporation paid or accrued taxes. If the corporation had income from, or paid or accrued taxes to, **more than one** foreign

country or U.S. possession, enter “**See attached**” and attach a schedule for each country for lines 15a through 15h.

Line 15b—Gross Income From All Sources

Enter the corporation’s gross income from all sources, including all U.S. and foreign source income.

Line 15c—Gross Income Sourced at Shareholder Level

Enter the total gross income of the corporation that is required to be sourced at the shareholder level. This includes income from the sale of most personal property other than inventory, depreciable property, and certain intangible property. See Pub. 514 and section 865 for details. Attach a schedule showing the following information:

- The amount of this gross income (without regard to its source) in each category identified in the instructions for line 15d, including each of the listed categories.
- Specifically identify gains on the sale of personal property other than inventory, depreciable property, and certain intangible property on which a foreign tax of 10% or more was paid or accrued. Also list losses on the sale of such property if the foreign country would have imposed a 10% or higher tax had the sale resulted in a gain. See **Sales or Exchanges of Certain Personal Property** in Pub. 514 and section 865.
- Specify foreign source capital gains or losses within each separate limitation category. Also separately identify foreign source gains or losses within each separate limitation category that are 28% rate gains and losses, unrecaptured section 1250 gains, and qualified 5-year gains.

Line 15d—Foreign Gross Income Sourced at Corporate Level

Separately report gross income from sources outside the United States by category of income as follows. See Pub. 514 for information on the categories of income.

Line 15d(1). Passive foreign source income.

Line 15d(2). Attach a schedule showing the amount of foreign source income included in each of the following listed categories of income:

- Financial services income;
- High withholding tax interest;
- Shipping income;
- Dividends from each noncontrolled section 902 corporation;
- Dividends from a domestic international sales corporation (DISC) or a former DISC;
- Distributions from a foreign sales corporation (FSC) or a former FSC;
- Section 901(j) income; and
- Certain income re-sourced by treaty.

Line 15d(3). General limitation foreign source income (all other foreign source income).

Line 15e—Deductions Allocated and Apportioned at Shareholder Level

Enter on line 15e(1) the corporation’s total interest expense (including interest equivalents under Temporary Regulations section 1.861-9T(b)). Do not include interest directly allocable under Temporary Regulations section 1.861-10T to income from a specific property. This type of interest is allocated and apportioned at the corporate level and is included on lines 15f(1) through (3). On line 15e(2), enter the total of all other deductions or losses that are required to be allocated at the shareholder level. For example, include on line 15e(2) research and experimental expenditures (see Regulations section 1.861-17(f)).

Line 15f—Deductions Allocated and Apportioned at Corporate Level to Foreign Source Income

Separately report corporate deductions that are apportioned at the corporate level to **(1)** passive foreign source income, **(2)** each of the listed foreign categories of income, and **(3)** general limitation foreign source income (see the instructions for line 15d). See Pub. 514 for more information.

Line 15g—Total Foreign Taxes

Enter in U.S. dollars the total foreign taxes (described in section 901 or section 903) that were paid or accrued by the corporation (according to its method of accounting for such taxes). Translate these amounts into U.S. dollars by using the applicable exchange rate (see Pub. 514).

Attach a schedule reporting the following information:

1. The total amount of foreign taxes (including foreign taxes on income sourced at the shareholder level) relating to each category of income (see instructions for line 15d).
2. The dates on which the taxes were paid or accrued, the exchange rates used, and the amounts in both foreign currency and U.S. dollars, for:
 - Taxes withheld at source on interest.
 - Taxes withheld at source on dividends.
 - Taxes withheld at source on rents and royalties.
 - Other foreign taxes paid or accrued.

Line 15h—Reduction in Taxes Available for Credit

Enter the total reductions in taxes available for credit. Attach a schedule showing the reductions for:

- Taxes on foreign mineral income (section 901(e)).
- Taxes on foreign oil and gas extraction income (section 907(a)).
- Taxes attributable to boycott operations (section 908).

- Failure to timely file (or furnish all of the information required on) Forms 5471 and 8865.

- Any other items (specify).

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.
- Mining exploration and development costs.

If a shareholder makes the election, the above 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 for which the deduction 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 27 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 21 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, see **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 21 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 or a real estate investment trust (REIT). As a shareholder of a regulated investment company or a REIT, the corporation will receive notice on **Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains**, of the amount of tax paid 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 12 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, 4, and 5, 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. Nonqualified withdrawals by the corporation from a capital construction fund.

16. Unrecaptured section 1250 gain. Figure this amount for each section 1250 property in Part III of Form 4797 (except property for which gain is reported using the installment method on Form 6252) for which you had an entry in Part I of Form 4797 by subtracting line 26g of Form 4797 from the **smaller** of line 22 or line 24 of Form 4797. Figure the total of these amounts for all section 1250 properties. Generally, the result is the corporation's unrecaptured section 1250 gain. However, if the corporation is reporting gain on the installment method for a section 1250 property held more than 1 year, see the next paragraph to figure the unrecaptured section 1250 gain on that property allocable to this tax year. Report each shareholder's pro rata share of the total amount as "Unrecaptured section 1250 gain."

The total unrecaptured section 1250 gain for an installment sale of section 1250 property held more than 1 year is figured in a manner similar to that used in the preceding paragraph. However, the total unrecaptured section 1250 gain must be allocated to the installment payments received from the sale. To do so, the corporation generally must treat the gain allocable to each installment payment as unrecaptured section 1250 gain until all such gain has been used in full. Figure the unrecaptured section 1250 gain for installment payments received during the tax year as the **smaller** of (a) the amount from line 26 or line 37 of Form 6252 (whichever applies) or (b) the total unrecaptured section 1250 gain for the sale reduced by all gain reported in prior years (excluding section 1250 ordinary income recapture). However, if the corporation chose not to treat all of the gain from payments received after May 6, 1997, and before August 24, 1999, as unrecaptured section 1250 gain, use only the amount the corporation chose to treat as unrecaptured section 1250 gain for those payments to reduce the total unrecaptured section 1250 gain remaining to be reported for the sale.

If the corporation received a Schedule K-1 or Form 1099-DIV from an estate, a trust, a REIT, or a mutual fund reporting "unrecaptured section 1250 gain," **do not** add it to the corporation's own unrecaptured section 1250 gain. Instead, report it as a separate amount. For example, if the corporation received a Form 1099-DIV from a REIT with unrecaptured section 1250 gain, report it as "Unrecaptured section 1250 gain from a REIT."

Also report as a separate amount any gain from the sale or exchange of an interest in a partnership attributable to unrecaptured section 1250 gain. See Regulations section 1.1(h)-1 and attach a statement required under Regulations section 1.1(h)-1(e).

17. If the corporation is a closely held S corporation (defined in section 460(b)(4)) and it depreciated certain property placed in service after September 13, 1995, under the income forecast method, it must attach to Form 1120S the information specified in the instructions for Form 8866, line 2, for the 3rd and 10th tax years beginning after the tax year the property was placed in service. It must also report the line 2 amounts to its shareholders. See the Instructions for Form 8866 for more details.

18. Amortization of reforestation expenditures. Report the amortizable basis and year in which the amortization began for the current year and the 7 preceding years. For limits that may apply, see section 194 and Pub. 535.

19. Any information needed by a shareholder to figure the interest due under section 1260(b). If any portion of a constructive ownership transaction was open in any prior year, each shareholder's tax liability must be increased by the shareholder's pro rata share of interest due on any deferral of gain recognition. See section 1260(b) for details, including how to figure the interest.

20. Any information needed by a shareholder to figure the extraterritorial income exclusion. See **Extraterritorial Income Exclusion** on page 11 for more information.

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

assigned to each short year under normal tax accounting rules, the year-end balance sheet should agree with the books and records at the end of the S short year.

Line 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.

Line 25—Adjustments to Shareholders' Equity

Some examples of adjustments to report on this line include:

- Unrealized gains and losses on securities held "available for sale."
- Foreign currency translation adjustments.
- The excess of additional pension liability over unrecognized prior service cost.
- Guarantees of employee stock (ESOP) debt.
- Compensation related to employee stock award plans.

If the total adjustment to be entered is a negative amount, enter the amount in parentheses.

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

Line 3b—Travel and Entertainment

Include on this line the part of the cost 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.

Specific Instructions

Schedule L—Balance Sheets per Books

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

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

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 E&P 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 E&P does not need to maintain the AAA in order to determine the tax effect of distributions.

Nevertheless, if an S corporation without accumulated E&P engages in certain transactions to which section 381(a) applies, such as a merger into an S corporation with accumulated E&P, 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.

On the first day of the corporation's first tax year as an S corporation, the balance of the AAA is zero. At the end of the tax year, adjust the AAA for the items for the tax year as explained below and in the order listed.

1. Increase the AAA by income (other than tax-exempt income) and the excess of the deduction for depletion over the basis of the property subject to depletion (unless the property is an oil and gas property the basis of which has been allocated to shareholders).

2. Generally, decrease the AAA by deductible losses and expenses, nondeductible expenses (other than expenses related to tax-exempt income and Federal taxes attributable to a C corporation tax year), and the sum of the shareholders' deductions for depletion for any oil or gas property held by the corporation as described in section 1367(a)(2)(E). However, if the total decreases under 2 exceeds the total increases under 1 above, the excess is a "net negative adjustment." If the corporation has a net negative adjustment, **do not** take it into account under 2. Instead, take it into account only under 4 below.

3. Decrease AAA (but not below zero) by property distributions (other than dividend distributions from accumulated E&P), unless the corporation elects to reduce accumulated E&P first. See **Distributions** below for definitions and other details.

4. Decrease AAA by any net negative adjustment. 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** below.

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 2001 tax year. If there is a beginning balance for the 2001 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 the AAA determined without regard to any net negative adjustment for the tax year (but not below zero). If distributions during the tax year exceed the AAA at the close of the tax year determined without regard to any net negative adjustment for 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)). 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 accumulated 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 accumulated E&P at the end of the tax year, reduced by any actual distributions of accumulated 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. In this example, the corporation has no PTI or accumulated E&P.

Items per return are:

- 1. Page 1, line 21 income—\$10,000
- 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 10 deduction—\$3,000

7. Schedule K, line 13 work opportunity 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 work opportunity 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.

For the AAA, the worksheet line 3—\$20,000 amount is the total of the Schedule K, lines 4a and 4b income 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 10 deduction of \$3,000, and the line 19 nondeductible expenses of \$6,000. The worksheet line 7 is zero. The AAA at the end of the tax year (figured without regard to distributions and the net negative adjustment of \$6,000) is zero, and distributions cannot reduce the AAA below zero.

For the other adjustments account, the worksheet line 3 amount is the Schedule K, line 17, tax-exempt interest income of \$5,000. The worksheet line 7 amount is \$5,000, reducing the other adjustments account to zero. The remaining \$60,000 of distributions are not entered on Schedule M-2.

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	10,000		
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	(6,000)	5,000	
7 Distributions other than dividend distributions	-0-	5,000	
8 Balance at end of tax year. Subtract line 7 from line 6	(6,000)	-0-	

Paperwork Reduction Act Notice. We ask for the information on this form 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.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

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	63 hr., 51 min.	23 hr., 9 min.	43 hr., 49 min.	5 hr., 21 min.
Sch. D (1120S)	11 hr., 14 min.	4 hr., 43 min.	9 hr., 46 min.	1 hr., 20 min.
Sch. K-1 (1120S)	16 hr., 30 min.	10 hr., 36 min.	15 hr., 4 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 3.

Codes for Principal Business Activity

This list of principal business activities and their associated codes is designed to classify an enterprise by the type of activity in which it is engaged to facilitate the administration of the Internal Revenue Code. These principal business activity codes are based on the North American Industry Classification System.

Using the list of activities and codes below, determine from which activity the company derives the largest percentage of its "total receipts." Total receipts is defined as the sum of gross receipts or sales (page 1, line 1a), all other income (page 1, lines 4 and 5), income (receipts only) reported on Schedule K, lines 3a and 4a through 4f, and income (receipts only) reported on Form 8825, lines 2, 19, and 20a. If the company purchases raw materials and supplies them to a subcontractor to produce the finished product, but retains title to the product, the company is considered a manufacturer and must use one of the manufacturing codes (311110-339900).

Once the principal business activity is determined, enter the six-digit code from the list below on page 1, item B. Also enter a brief description of the business activity on page 2, Schedule B, line 2(a) and the principal product or service of the business on line 2(b).

Agriculture, Forestry, Fishing and Hunting

Code

Crop Production

111100 Oilseed & Grain Farming
111210 Vegetable & Melon Farming (including potatoes & yams)
111300 Fruit & Tree Nut Farming
111400 Greenhouse, Nursery, & Floriculture Production
111900 Other Crop Farming (including tobacco, cotton, sugarcane, hay, peanut, sugar beet & all other crop farming)

Animal Production

112111 Beef Cattle Ranching & Farming
112112 Cattle Feedlots
112120 Dairy Cattle & Milk Production
112210 Hog & Pig Farming
112300 Poultry & Egg Production
112400 Sheep & Goat Farming
112510 Animal Aquaculture (including shellfish & finfish farms & hatcheries)
112900 Other Animal Production

Forestry and Logging

113110 Timber Tract Operations
113210 Forest Nurseries & Gathering of Forest Products
113310 Logging

Fishing, Hunting and Trapping

114110 Fishing
114210 Hunting & Trapping

Support Activities for Agriculture and Forestry

115110 Support Activities for Crop Production (including cotton ginning, soil preparation, planting, & cultivating)
115210 Support Activities for Animal Production
115310 Support Activities For Forestry

Mining

211110 Oil & Gas Extraction
212110 Coal Mining
212200 Metal Ore Mining
212310 Stone Mining & Quarrying
212320 Sand, Gravel, Clay, & Ceramic & Refractory Minerals Mining & Quarrying
212390 Other Nonmetallic Mineral Mining & Quarrying
213110 Support Activities for Mining

Utilities

221100 Electric Power Generation, Transmission & Distribution
221210 Natural Gas Distribution
221300 Water, Sewage & Other Systems

Construction

Code

Building, Developing, and General Contracting

233110 Land Subdivision & Land Development
233200 Residential Building Construction
233300 Nonresidential Building Construction

Heavy Construction

234100 Highway, Street, Bridge, & Tunnel Construction
234900 Other Heavy Construction

Special Trade Contractors

235110 Plumbing, Heating, & Air-Conditioning Contractors
235210 Painting & Wall Covering Contractors
235310 Electrical Contractors
235400 Masonry, Drywall, Insulation, & Tile Contractors
235500 Carpentry & Floor Contractors
235610 Roofing, Siding, & Sheet Metal Contractors
235710 Concrete Contractors
235810 Water Well Drilling Contractors
235900 Other Special Trade Contractors

Manufacturing

Food Manufacturing

311110 Animal Food Mfg
311200 Grain & Oilseed Milling
311300 Sugar & Confectionery Product Mfg
311400 Fruit & Vegetable Preserving & Specialty Food Mfg
311500 Dairy Product Mfg
311610 Animal Slaughtering and Processing
311710 Seafood Product Preparation & Packaging
311800 Bakeries & Tortilla Mfg
311900 Other Food Mfg (including coffee, tea, flavorings & seasonings)

Beverage and Tobacco Product Manufacturing

312110 Soft Drink & Ice Mfg
312120 Breweries
312130 Wineries
312140 Distilleries
312200 Tobacco Manufacturing

Textile Mills and Textile Product Mills

313000 Textile Mills
314000 Textile Product Mills

Apparel Manufacturing

315100 Apparel Knitting Mills
315210 Cut & Sew Apparel Contractors
315220 Men's & Boys' Cut & Sew Apparel Mfg
315230 Women's & Girls' Cut & Sew Apparel Mfg

Code

315290 Other Cut & Sew Apparel Mfg
315990 Apparel Accessories & Other Apparel Mfg

Leather and Allied Product Manufacturing

316110 Leather & Hide Tanning & Finishing
316210 Footwear Mfg (including rubber & plastics)
316990 Other Leather & Allied Product Mfg

Wood Product Manufacturing

321110 Sawmills & Wood Preservation
321210 Veneer, Plywood, & Engineered Wood Product Mfg
321900 Other Wood Product Mfg

Paper Manufacturing

322100 Pulp, Paper, & Paperboard Mills
322200 Converted Paper Product Mfg

Printing and Related Support Activities

323100 Printing & Related Support Activities

Petroleum and Coal Products Manufacturing

324110 Petroleum Refineries (including integrated)
324120 Asphalt Paving, Roofing, & Saturated Materials Mfg
324190 Other Petroleum & Coal Products Mfg

Chemical Manufacturing

325100 Basic Chemical Mfg
325200 Resin, Synthetic Rubber, & Artificial & Synthetic Fibers & Filaments Mfg
325300 Pesticide, Fertilizer, & Other Agricultural Chemical Mfg
325410 Pharmaceutical & Medicine Mfg
325500 Paint, Coating, & Adhesive Mfg
325600 Soap, Cleaning Compound, & Toilet Preparation Mfg
325900 Other Chemical Product & Preparation Mfg

Plastics and Rubber Products Manufacturing

326100 Plastics Product Mfg
326200 Rubber Product Mfg

Nonmetallic Mineral Product Manufacturing

327100 Clay Product & Refractory Mfg
327210 Glass & Glass Product Mfg
327300 Cement & Concrete Product Mfg
327400 Lime & Gypsum Product Mfg
327900 Other Nonmetallic Mineral Product Mfg

Primary Metal Manufacturing

331110 Iron & Steel Mills & Ferroalloy Mfg
331200 Steel Product Mfg from Purchased Steel
331310 Alumina & Aluminum Production & Processing
331400 Nonferrous Metal (except Aluminum) Production & Processing
331500 Foundries

Fabricated Metal Product Manufacturing

332110 Forging & Stamping
332210 Cutlery & Handtool Mfg
332300 Architectural & Structural Metals Mfg
332400 Boiler, Tank, & Shipping Container Mfg
332510 Hardware Mfg
332610 Spring & Wire Product Mfg
332700 Machine Shops; Turned Product; & Screw, Nut, & Bolt Mfg
332810 Coating, Engraving, Heat Treating, & Allied Activities
332900 Other Fabricated Metal Product Mfg

Code

Machinery Manufacturing

333100 Agriculture, Construction, & Mining Machinery Mfg
333200 Industrial Machinery Mfg
333310 Commercial & Service Industry Machinery Mfg
333410 Ventilation, Heating, Air-Conditioning, & Commercial Refrigeration Equipment Mfg
333510 Metalworking Machinery Mfg
333610 Engine, Turbine & Power Transmission Equipment Mfg
333900 Other General Purpose Machinery Mfg

Computer and Electronic Product Manufacturing

334110 Computer & Peripheral Equipment Mfg
334200 Communications Equipment Mfg
334310 Audio & Video Equipment Mfg
334410 Semiconductor & Other Electronic Component Mfg
334500 Navigational, Measuring, Electromedical, & Control Instruments Mfg
334610 Manufacturing & Reproducing Magnetic & Optical Media

Electrical Equipment, Appliance, and Component Manufacturing

335100 Electric Lighting Equipment Mfg
335200 Household Appliance Mfg
335310 Electrical Equipment Mfg
335900 Other Electrical Equipment & Component Mfg

Transportation Equipment Manufacturing

336100 Motor Vehicle Mfg
336210 Motor Vehicle Body & Trailer Mfg
336300 Motor Vehicle Parts Mfg
336410 Aerospace Product & Parts Mfg
336510 Railroad Rolling Stock Mfg
336610 Ship & Boat Building
336990 Other Transportation Equipment Mfg

Furniture and Related Product Manufacturing

337000 Furniture & Related Product Manufacturing

Miscellaneous Manufacturing

339110 Medical Equipment & Supplies Mfg
339900 Other Miscellaneous Manufacturing

Wholesale Trade

Wholesale Trade, Durable Goods

421100 Motor Vehicle & Motor Vehicle Parts & Supplies Wholesalers
421200 Furniture & Home Furnishing Wholesalers
421300 Lumber & Other Construction Materials Wholesalers
421400 Professional & Commercial Equipment & Supplies Wholesalers
421500 Metal & Mineral (except Petroleum) Wholesalers
421600 Electrical Goods Wholesalers
421700 Hardware, & Plumbing & Heating Equipment & Supplies Wholesalers
421800 Machinery, Equipment, & Supplies Wholesalers
421910 Sporting & Recreational Goods & Supplies Wholesalers
421920 Toy & Hobby Goods & Supplies Wholesalers
421930 Recyclable Material Wholesalers
421940 Jewelry, Watch, Precious Stone, & Precious Metal Wholesalers
421990 Other Miscellaneous Durable Goods Wholesalers

<p>Code</p> <p>Wholesale Trade, Nondurable Goods</p> <p>422100 Paper & Paper Product Wholesalers</p> <p>422210 Drugs & Druggists' Sundries Wholesalers</p> <p>422300 Apparel, Piece Goods, & Notions Wholesalers</p> <p>422400 Grocery & Related Product Wholesalers</p> <p>422500 Farm Product Raw Material Wholesalers</p> <p>422600 Chemical & Allied Products Wholesalers</p> <p>422700 Petroleum & Petroleum Products Wholesalers</p> <p>422800 Beer, Wine, & Distilled Alcoholic Beverage Wholesalers</p> <p>422910 Farm Supplies Wholesalers</p> <p>422920 Book, Periodical, & Newspaper Wholesalers</p> <p>422930 Flower, Nursery Stock, & Florists' Supplies Wholesalers</p> <p>422940 Tobacco & Tobacco Product Wholesalers</p> <p>422950 Paint, Varnish, & Supplies Wholesalers</p> <p>422990 Other Miscellaneous Nondurable Goods Wholesalers</p>	<p>Code</p> <p>Clothing and Clothing Accessories Stores</p> <p>448110 Men's Clothing Stores</p> <p>448120 Women's Clothing Stores</p> <p>448130 Children's & Infants' Clothing Stores</p> <p>448140 Family Clothing Stores</p> <p>448150 Clothing Accessories Stores</p> <p>448190 Other Clothing Stores</p> <p>448210 Shoe Stores</p> <p>448310 Jewelry Stores</p> <p>448320 Luggage & Leather Goods Stores</p> <p>Sporting Goods, Hobby, Book, and Music Stores</p> <p>451110 Sporting Goods Stores</p> <p>451120 Hobby, Toy, & Game Stores</p> <p>451130 Sewing, Needlework, & Piece Goods Stores</p> <p>451140 Musical Instrument & Supplies Stores</p> <p>451211 Book Stores</p> <p>451212 News Dealers & Newsstands</p> <p>451220 Prerecorded Tape, Compact Disc, & Record Stores</p> <p>General Merchandise Stores</p> <p>452110 Department stores</p> <p>452900 Other General Merchandise Stores</p> <p>Miscellaneous Store Retailers</p> <p>453110 Florists</p> <p>453210 Office Supplies & Stationery Stores</p> <p>453220 Gift, Novelty, & Souvenir Stores</p> <p>453310 Used Merchandise Stores</p> <p>453910 Pet & Pet Supplies Stores</p> <p>453920 Art Dealers</p> <p>453930 Manufactured 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Messengers</p> <p>492110 Couriers</p> <p>492210 Local Messengers & Local Delivery</p> <p>Warehousing and Storage</p> <p>493100 Warehousing & Storage (except lessors of miniwarehouses & self-storage units)</p> <p>Information</p> <p>Publishing Industries</p> <p>511110 Newspaper Publishers</p> <p>511120 Periodical Publishers</p> <p>511130 Book Publishers</p> <p>511140 Database & Directory Publishers</p> <p>511190 Other Publishers</p> <p>511210 Software Publishers</p> <p>Motion Picture and Sound Recording Industries</p> <p>512100 Motion Picture & Video Industries (except video rental)</p> <p>512200 Sound Recording Industries</p> <p>Broadcasting and Telecommunications</p> <p>513100 Radio & Television Broadcasting</p> <p>513200 Cable Networks & Program Distribution</p> <p>513300 Telecommunications (including paging, cellular, satellite, & other telecommunications)</p> <p>Information Services and Data Processing Services</p> <p>514100 Information Services (including news syndicates, libraries, & on-line information services)</p> <p>514210 Data Processing Services</p>	<p>Code</p> <p>523210 Securities & Commodity Exchanges</p> <p>523900 Other Financial Investment Activities (including portfolio management & investment advice)</p> <p>Insurance Carriers and Related Activities</p> <p>524140 Direct Life, Health, & Medical Insurance & Reinsurance Carriers</p> <p>524150 Direct Insurance & Reinsurance (except Life, Health & Medical) Carriers</p> <p>524210 Insurance Agencies & Brokerages</p> <p>524290 Other Insurance Related Activities</p> <p>Funds, Trusts, and Other Financial Vehicles</p> <p>525100 Insurance & Employee Benefit Funds</p> <p>525910 Open-End Investment Funds (Form 1120-RIC)</p> <p>525920 Trusts, Estates, & Agency Accounts</p> <p>525930 Real Estate Investment Trusts (Form 1120-REIT)</p> <p>525990 Other Financial Vehicles</p> <p>For 551111 "Offices of Bank Holding Companies" and 551112 "Offices of Other Holding Companies," see Management of Companies (Holding 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