Subchapter S Tax Option for Small Businesses

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Since Abraham Lincoln imposed the first federal income tax upon American citizens in 1861 to finance the Civil War, both the government and taxpayers have constantly sought changes in the Internal Revenue Code to make for more equitable taxes, to encourage enterprise, and to provide funds for government purposes. The first taxes were imposed on citizens at a rate of 3 percent on most incomes between $600 and $10,000 and a rate of 5 percent on all income in excess of $10,000.\(^1\)

With the popularity of the corporate structure of business, the government set forth regulations in 1909 to tax the income of the large number of capitalizing concerns at a rate of one percent on all income in excess of $5,000. As population and trade grew at an alarming rate, so did the corporate enterprises. Rapidly an economic system that once had been totally composed of local businesses with only a few shareholders grew to such proportions that international concerns such as Xerox, with thousands of shareholders, came to dominate the business of America. Although the small businesses far outnumbered the giant conglomerates, tax laws seemed to be geared toward the larger corporations who generated the bulk of tax revenues. Many small- and medium-sized businesses found it difficult to find shareholders to capitalize a concern with a small amount of revenue which was taxed twice—once as a corporate revenue and secondly as dividend income to shareholders. In an
attempt to save the diminishing small business, Congress in 1954 first considered a bill to give tax relief to the "little people".

Subchapter S was adopted in 1958, as part of the so called "small business" legislation of that year. It represents an attempt to achieve a measure of tax neutrality in resolving the difficult problem of whether a business should be conducted as a sole proprietorship, partnership, or corporation. In general, it permits closely held corporations an elective treatment under which the corporation is not subject to tax on its income (except some long-term capital gains), but instead the shareholders are subject to tax on that income whether distributed to them as a dividend or retained in the corporation. Through election any nontax advantages inherent in operation in corporate form are made available to the electing small business corporation. Size of assets or amount of income is not a factor in determining eligibility. Election of Subchapter S treatment by a corporation ends its liability for any federal income tax, but the corporation must continue to file an annual information return.

REQUIREMENTS

As defined in Regulation 1371, certain requirements must be met before a corporation is eligible for the election as a small business corporation:
1) It must be a domestic corporation,

2) It must not be a member of an affiliated group,

3) It must have only one class of stock,

4) It must not have more than ten shareholders (exceptions are discussed later),

5) It must have only individuals, estates, or certain trusts as shareholders,

6) It must not have a nonresident alien as a shareholder.

In addition, an election continuity requirement is as follows:

It may not have more than twenty percent of its gross receipts from royalties, certain rents, dividends, interest, annuities, and gains on sales or exchanges of stock or securities. (Only the gains from such sales or exchanges are considered as a part of gross receipts.) This condition does not apply during the first two years of business if "passive" investment income is less than $3,000.

As a domestic corporation, the company must be formed in the United States or under the laws of the United States, any state, or Territory.

It is possible for a Subchapter S corporation to have more than one class of stock, provided the voting and dividend rights and liquidation preference applicable to each share are equal, causing in effect the corporation to have the equivalent of one class of stock.

Simply defined, an affiliated group is one or more includible corporations connected through stock ownership with a common parent. At least eighty percent of
stock, except nonvoting stock limited and preferred to
dividends, is owned singly or collectively by one or
more of the other includible corporations. Code 1371(d)
was added in 1964 to recognize that inactive affiliates,
established with an eye to the future, provide an excep-
tion to the general rule in 1371(a). If the inactive
affiliate does not engage in business or produce taxable
income, this provision does not apply.

The corporation may not have any nonresident alien
shareholders. This restriction reflects the fact that
the corporate income is exempt from tax under Subchapter
S under the assumption that it will be subjected to the
graduated individual income tax rates, whereas some
nonresident aliens are taxed at the flat rate of 30
percent. 7

SHAREHOLDER REQUIREMENTS

The area of shareholder requirements is one which
is of particular concern to corporate officials. Death
of a shareholder, sale of stock, or personality conflicts
can conceivably cause the election to be lost. Termina-
tion would be effective as of the beginning of the tax
year in which any requirement is no longer met, rather
than at the time of termination.

Identification of shareholders required to consent
is sometimes tricky—in some cases consent may be required
if one is not a shareholder. Under Section 1372(a),
all persons who are shareholders on the first day of the year or on the date the election is made, whichever is later, must file a consent to the corporation's election.\textsuperscript{8}

After the initial election, a new shareholder must consent to the termination of the election within sixty days after becoming a shareholder. This eliminates many of the timing problems encountered previously when assenting shareholders were required to file their consent.

The number of shareholders is limited to ten; the Tax Reform Act of 1976 provided that for years beginning after December 31, 1976, this limitation increases to fifteen once a small business corporation has the election in effect for five consecutive years. Once this five-year rule has been satisfied, it is in effect after a corporation again decides for a valid election after a revocation or termination. The permanent increase to fifteen is intended to prevent a potential problem where the Subchapter S election is terminated or revoked after the corporation is permitted to have fifteen shareholders and the number of shareholders has in fact increased to more than ten.\textsuperscript{9}

In community property states, separate ownership of shares by husband and wife is considered as ownership by one, even when additional shares are owned jointly. However, in those states which do not have community property laws, individual ownership by husband and
wife constitutes two shareholders as indicated in Subchapter S provisions. In any case, consent by both husband and wife is necessary if their stock is held as joint tenants, tenants in common, tenants by the entirety, or as community property.

When one spouse dies and ownership of jointly held Subchapter S stock is transferred to an estate, the surviving spouse and estate are counted as one in determining the number of shareholders. If all shares of the estate are owned jointly and pass to the surviving spouse, no problem is created; after the death of the deceased shareholder there is only one shareholder, the surviving spouse. Former regulations dictated that if there had been ten shareholders prior to the establishment of the estate and the estate was recognized as an additional taxpayer (as occurs when a couple owns stock jointly and the deceased owned stock in his name only), the election would not be available because the ten shareholder limitation would not be met.

Current guidelines provide that the number of shareholders of the corporation may be increased to a number greater than ten but less than fifteen if the increase results solely through the passing of stock through inheritance. Once the number of shareholders has increased over ten as a result of inheritances, the new maximum number becomes permanent,10 so as not to have a restriction as to the transferability of shares
during the five-year period. Shares may be sold or transferred to individuals other than those who are present shareholders.

A minor is counted as a shareholder and consent may be given by the minor or legal guardian.

For the years after 1976, grantor trusts, voting trusts, and trusts to which stock is transferred pursuant to the terms of a will (but only for a 60-day period beginning on the date of transfer from the estate to the trust) may be valid stockholders. In the case of a voting trust, however, each beneficiary of the trust is considered to be a shareholder for purposes of determining the maximum number of shareholders.

In cases where stock is held by a nominee, agent, guardian, or custodian, the individual who receives the benefit is the person to be counted as shareholder, even if it is not readily apparent that he is the beneficial owner.

A person can be a shareholder even though no shares have been issued to him if he is a subscriber to the stock and if subscribers are considered shareholders in the particular state. If a corporation is in the development stages and no actual shareholders are on record, subscribers of stock will find it necessary to file consent in regard to the corporation's desire for election, in accordance with timely restrictions.
outlined by the Internal Revenue Service.

In *Hoffman*, 47 TC 218(1966), the Tax Court decreed that consent is necessary by the one who must include Subchapter S income on his Form 1040. The case involved a sale of shares by the mother to son, with several payments being made. Prior to the final payment the stock was to be kept in escrow, with transfer occurring after the final payment. The Court based their decision on prior cases concerned with who was to pay the tax on the dividend during escrow—the purchaser. In short, no consent is required by shareholders if they do not participate in the corporation’s successes or failures, and thus do not bear economic and tax consequences of the election.

Previously, in an unfortunate situation where a shareholder died and the shares were in possession of an estate, a consent must have been filed within thirty days by an executor even though the stock passed directly to an heir under law. This provision was often overlooked in the days following a death; an extension of time could have been obtained even though the thirty-day period had lapsed. However, the executor had to demonstrate that there was reasonable cause for failure to comply with the consent requirement and that the Government’s position would not be jeopardized if the extension was granted. To avoid this problem, the testator could have directed, through a provision in
his will, that the executor maintain the election. As mentioned earlier, current provisions require timely filing of the refusal to consent; the positive consentor is not required to expend any effort in filing Form 2553--the election continues automatically.

TIMING REQUIREMENTS

One of the prerequisites of the election is the timeliness of filing. Whether the corporation be new, preexisting, or a previously electing Subchapter S corporation, the Code has specific requirements for each. The following is a brief attempt to differentiate and clarify these requirements.

For the newly formed corporation, the primary concern is determination of when the corporation's first tax year begins. If a corporation fails to meet the election during the required time period, it is not prevented from making an election in a later tax year in which it meets all the qualifications required for election. The following is one definition of when the first month begins: "the first month of the taxable year of a new corporation does not begin until the corporation has shareholders or acquires assets or begins doing business, whichever is the first to occur."13 None of these can occur until the corporation comes into existence with the issuance of certificates of incorporation as provided by the various state laws.
The simplicity of the words of the regulation is not indicative of the difficulties to be encountered in interpretation of the Internal Revenue Code.

For the new corporation whose tax year begins on other than the first of a month, "month" refers to the period beginning with the first day of the tax year and ending with the day preceding the numerically corresponding day of the succeeding month. If there is no such corresponding day, the month ends with the last day of the next month. All persons who are shareholders on the first day of a new corporation's tax year must file a consenting Form 2553.

A new corporation electing some fiscal year other than the calendar year must be wary of meeting the requirements necessary to elect a fiscal year. If invalid, the company is automatically placed on a calendar year, possibly making the election for Subchapter S invalid. The election for fiscal year can be made in either of two ways: 1) filing the initial return on the same basis of the desired fiscal year or 2) filing Form 7004 indicating the desired fiscal year. The company must maintain the books on the basis of the desired fiscal year, with adoption of the fiscal year made on or before the due date of Form 1120S.

If an election for Subchapter S is filed prior to the legal existence of the corporation (before the first month begins, as defined in the Code) or after
incorporation but before the acquisition of assets, beginning of business or having shareholders, it will be held to be invalid. Corporate officials must be aware of state laws determining when one becomes a shareholder. In California, a subscriber to stock is a shareholder if there are no actual shares outstanding. It is advised that corporate officials consult legal authorities in order to avoid difficulties and possible invalidation of their election.

Tax Court rulings make no distinction between operating assets (factory machinery, delivery trucks, etc.) and passive assets (cash, loan proceeds). Yet organization costs must not be considered in determination of timing of acquisition of assets--some must be acquired in the organization of most corporations. With a firm's ability to obtain a loan previous to acquiring shareholders, assets may be acquired. In much the same way, it would be possible for a corporation to begin business before having assets or shareholders. Negotiating service contracts, signing a lease and acquiring a local or state license to do business is indicative of the nature of the business.

If one were to postpone election until after the corporation has definitely begun to conduct business, close the year, file a short period return as a corporation and then file the Form 2553 for election in the
month preceding or following the close of the short year, the difficulties of timing mentioned above would be avoided. Of course, if this technique is used and it results in the corporation being on a fiscal year, the requirements for electing a fiscal year must be met. The obvious disadvantages of foregoing the Subchapter S election until the corporation has definitely begun business is that a few months of net operating loss may be wasted, and the resulting year end may not be ideal.15

For a preexisting corporation, consent must be filed by shareholders within the month preceding or following the first day of the tax year. If filing is done outside of this two-month time span, the election will be held to be invalid; this does not prevent the corporation from filing for election the following tax year.

If an election has been terminated or revoked, the corporation must be granted permission by the Internal Revenue Service to again elect tax-option corporation status within the five years following the revocation or termination. Thereafter, the procedure is the same as described above for an existing corporation. If under the previous Subchapter S election the number of stockholders had increased to some figure between eleven and fifteen inclusive, this right is fixed with the reelecting business. The Senate Report accompanying
the Tax Reform Act of 1976 explains, "...that the 5-year rule should not be required to be satisfied in conjunction with a subsequent election where it was previously satisfied under an earlier election and the corporation had in fact more than ten shareholders on the last day of the last taxable year covered by the previous election." Even if the corporation did not take advantage of the increase in five shareholders possible after the five-year test has been met, the fifteen shareholders rule is applicable for the reelection without regard to the actual number of shareholders. 16

TERMINATION

Termination of the Subchapter S election, resulting in taxation under corporate tax laws, occurs when any of the six conditions necessary to elect are not met. A new shareholder cannot act to terminate the election by failing to file a Form 2553; if he wishes to terminate Subchapter S tax status he must file a timely election stating so.

Some consideration must be given to the possibility of a shareholder selling or transferring ownership of his shares to an individual not desiring to continue the Subchapter S election. If this would happen, the remaining shareholders would lose because distributions to them would be subject to the corporate income tax
and the individual income tax on dividends. In an attempt to avoid such an unfortunate situation, it is advisable that shareholders be subject to a written agreement to protect the election. This agreement can provide for two possibilities: 1) the seller of shares, in the written sales contract, provides that the new shareholder will not act to terminate the election, or 2) the seller will give the corporation or other stockholders first refusal before he sells or transfers any of his stock. 17

It is necessary that a shareholder be required to hold his shares for his own account, rather than as a nominee. In the former situation, a potential shareholder must agree to consent to the election as a prerequisite to becoming a shareholder and if he attempts to transfer shares to another individual, the current shareholder must require agreement to the election as a part of the sales contract by the individual desiring to become a shareholder of the Subchapter S corporation.

It is common for corporate officials to overlook the 20 percent maximum revenue from royalties, certain rents, dividends, interest, annuities, and gains on sales or exchanges of stock or securities. A close check of receipts a month prior to the year end would allow time to possibly counteract the 20 percent revenue termination.

Termination may be brought about by unanimous
consent of all shareholders, provided this decision is made during the first month of a tax year to be effective that year. The unanimous consent is necessary to show that consideration by all shareholders has occurred and all are aware of the desires of all other shareholders.

The Internal Revenue Service can find due cause to revoke the election, usually because of failure to meet one of the seven requirements. Whatever the reason for revocation or termination, a new election may not be made until the fifth year after the year for which the election was not valid, unless the Internal Revenue Service gives explicit permission to the corporation.

ALLOCATION OF INCOME

GENERAL COMMENT

Although a corporation that qualifies under Subchapter S is not subject to corporate tax for the years during which such election is effective, and its income is taxable to the stockholders in a manner somewhat analogous to the treatment of partnership income, there are certain substantial differences in the method of taxing the income of a Subchapter S corporation and that of a partnership.18
CAPITAL GAINS TAX

Most income and expense items lose their characteristics for special tax treatment when passed through to shareholders. One exception, noted in Section 1375(a)(1), states the excess of the net long-term capital gain over a firm's net short-term capital loss is entitled to long-term capital gain treatment at shareholder level. This capital gains treatment applies to actual and constructive dividends, whether or not the shareholder owned any stock at the close of the corporation's tax year; this pass through of capital gain is limited only to distributions out of current earnings and profits. A tax is assessed on the electing corporation if the following requirements are met:

1) The taxable income must exceed $25,000,

2) The excess of the net long-term capital gain over the net short-term capital loss must be greater than $25,000, and

3) The excess of net long-term capital gain over net short-term capital gain must exceed 50 percent of taxable income for the year.

If a corporation has had a valid election in effect for the three previous tax years or a new corporation has operated under Subchapter S status since its inception, the tax will not apply. These two provisions tend to eliminate the use of the election on a "one-shot" basis to avoid the tax on corporate capital gains. If the sale meets the requirements of the installment tax
method of recognizing gains, it may be possible to
avoid the corporate capital gains tax. This is accom­
plished by either spreading the gain over a number of
years or by making sure, through long range planning,
that noncapital gain income exceeds the capital gain
income each year.

Despite these exceptions, the tax will apply to
gains and losses from the disposition of certain
property by an electing corporation if

1) The property was acquired in the year
in question or within the 36 months
preceding the year in question,

2) The property was acquired from a
corporation that was not itself an
electing corporation during all of
this period up to the time of the
acquisition, and

3) The property has a basis to the
Subchapter S corporation determined
by reference to its basis in the
hands of the transferor corporation.

It is relevant to note at this point that consid­
eration of the activities of the shareholders must be
made. Section 1375(d)(1) states, "...if an electing
 corporation is availed of by any shareholders or group
 of shareholders owning a substantial portion of the stock
 of such corporation for the purpose of selling property
 which in the hands of such shareholder or shareholders
 would not have been an asset, gain from the sale of which
 would be capital gain, then the gain on the sale of such
 property by the corporation shall not be treated as a
capital gain." Thus, a real estate agent could not convert ordinary income into capital gain by selling real estate through a Subchapter S corporation.

The corporate capital gains tax is the lesser of:

1) Thirty percent of the amount by which the excess of the net long-term capital gain over the net short-term capital loss exceeds $25,000, or

2) The tax that would have been imposed on its taxable income had the corporation not been a Subchapter S corporation (using the 20-22-48% method).

The gain passed through to shareholders as a net long-term gain is reduced by the amount of this tax and also by any minimum tax on tax preferences. Long-term capital gains retain their character when passed through to shareholders.

If a Subchapter S corporation is subject to the capital gains tax, it may also be subject to a 15 percent minimum tax. An additional tax of 15 percent on certain items which have received very favorable tax treatment (such as accelerated depreciation, amortization of pollution control facilities, depletion) may be imposed. For a Subchapter S corporation, the tax is levied only against the capital gain preference item (that is subject to a corporate tax) after subtracting an exemption (the greater of $10,000 or one-half of the regular income tax for the year).22

Tax preferences are accumulated at the corporate
level and passed through to shareholders on a daily basis, in the same manner that operating losses are passed. The preferences are reduced by the amount of capital gains tax and minimum tax paid at the corporate level.

Net short-term capital gains are added to other income in arriving at undistributed taxable income of the corporation.

Net capital losses do not flow through to shareholders, but are retained within the corporation for carrying forward five years for application against capital gains. There is no carryback of net capital losses under Subchapter S guidelines.

NET OPERATING LOSS

The pass through of corporate losses is restricted to the net operating loss. As mentioned earlier, the capital loss of a corporation is retained for application to capital gains in the succeeding five taxable years. Net operating losses are allocated on a daily basis to all persons who held shares during the taxable year. The amount passed through cannot exceed the sum of the shareholder's adjusted basis in stock plus any loans to the corporation; a shareholder's basis in the corporation cannot be reduced below zero. (In this way a Subchapter S corporation is much like a partnership--the partner can deduct his distributive share of
partnership losses only to the extent of his adjusted basis in the business.) The loss is first applied to the basis of stock and secondly to any corporate indebtedness held by the shareholder. Any excess is lost to the shareholder for carryforward or carryback purposes.

Under Section 1374, each shareholder of an electing corporation carries his share of the corporation's net operating loss over to his individual return to be applied against his other income. Any unused excess is carried back three years and forward five years by the shareholder in the usual manner provided by Section 172.24

Because a shareholder's basis in a corporation may not be adequate to absorb his share of net operating loss, particularly in the development years of a corporation, analysis of each shareholder's basis should be made prior to the Subchapter S's year end. If it is evident that some individual's basis might be insufficient to absorb the expected loss, steps may be taken to increase the basis through additional loans or the purchase of additional stock. Care must be taken to determine if this additional investment will be secure with regards to the expected future earnings of the corporation. Simply stated, the net operating loss belongs exclusively to the shareholders, but they
may use it only to the extent of the basis of their investment in the corporation.

UNDISTRIBUTED TAXABLE INCOME (UTI)

James R. Haney describes the double taxation of corporate income as inequitable:

"The basic concept of integration is that the real beneficiary of corporate income is the shareholder, and the tax should be imposed at his individual rate structure. Any tax above that level is a punitive tax on ownership through the corporate form."29

Since a Subchapter S corporation is not subject to an income tax at the corporate level, the income is taxed directly to shareholders as though it were distributed on a pro rata basis on the last day of the corporation's fiscal or calendar year, regardless of whether the income was actually distributed as dividends or not. If actually distributed, this action can occur during the current year or within two and one-half months after year end.

The current year's taxable income is called undistributed taxable income, and is subject to certain deductions not allowed:

1) The deduction for net operating losses incurred in other years,

2) The 85 percent dividend received deduction,

3) The partially tax-exempt interest deduction, and

4) The deduction for dividends paid on certain preferred stock.
Once taxable income is computed, undistributed taxable income can be determined. In this regard taxable income is reduced by:

1) Any penalty tax imposed on capital gains,

2) The minimum tax, and

3) The sum of money distributed as dividends during the tax year out of current earnings and profits.

Thus, only cash dividends reduce undistributed taxable income, and distributions of property other than money do not. 26

Upon determination of the business's taxable income, the basis of each shareholder's stock is increased in reflection of ownership on the last day of the year end. Since the shareholder's status is determined as of the last day of the taxable year, it will be possible to transfer stock to a member of the family for income splitting purposes at the last minute, subject to general assignment-of-income and similar principles. 27

PREVIOUSLY TAXED INCOME (PTI)

West's Federal Taxation defines previously taxed income (PTI) as "income that remains in the corporation and has been taxed to the shareholders as a constructive dividend. UTI becomes PTI two and one-half months after the close of the corporation's tax year." As a previous element of UTI, the distribution has been taxed
in some previous period and accordingly is not subject to a current tax. As such, a PTI distribution results in a reduction in the shareholder's basis in stock investment.

Assuming Subchapter S status is in effect, previously taxed income cannot be distributed tax-free until current undistributed taxable income is first distributed (i.e., the order works on a LIFO principle). Once the election is terminated, previously taxed income can be distributed only after current and accumulated earnings and profits are first distributed. The right to receive distribution of previously taxed income is not transferable--one does not acquire PTI with the purchase of stock. A good example is an estate which does not inherit the decedent's PTI amount. If the shareholder sells only part of his stock, the entire amount of previously taxed income is available for future distributions to him as long as he retains even one share of stock.

If the Subchapter S election is terminated or revoked, the execution of the right to make a distribution of PTI becomes more difficult. Thus, a distribution that would have been shielded by Section 1375(d) if the Subchapter S election had remained in effect may constitute a dividend if made after the election is terminated; in reality this distribution would be taxed twice to shareholders--once as UTI and secondly
as a dividend.

Shareholders might consider distribution of all undistributed taxable income currently, but any corporation interested in growth will consider this impossible since the distribution must be made in cash rather than property or services. 30

NONTAX ADVANTAGES OF SUBCHAPTER S ELECTION

The Subchapter S election entails numerous tax and nontax advantages as compared with the partnership form of business. Among the nontax advantages inherent in the election are:

1) As a corporation, there is continuity of existence. Death or withdrawal of an owner will not disrupt the legal structure; only the shareholders or courts can opt for liquidation.

2) Stockholders are free to sell their share of ownership in any way they see fit, provided it is in accordance with the corporate charter.

3) Of primary interest to those just beginning a business, there is liability limited to the shareholders' amount of stock investment. This is an obvious advantage over the general partnership where creditors may absorb partners' personal assets in seeking to satisfy partnership debt.

TAX ADVANTAGES OF ELECTION

Besides legal qualities which appeal to electors of Subchapter S, there are several tax consequences attractive to the electing corporation and shareholders,
particularly if shareholders are in a lower tax bracket than the corporation. These include:

1) Elimination of the corporate tax, avoiding the double taxation of corporate earnings.

2) Net operating losses are passed through to shareholders to offset other income.

3) With proper foresight, a one-shot election may be made for the purpose of passing through nonrecurring capital gains from the sale of corporate property.

4) The possibility of deferral of capital gain when corporate assets are sold on the installment method.

DISADVANTAGES OF ELECTION

Careful evaluation of the corporation's future plans for growth and profitability must be made in consideration of the election to be taxed as a small business corporation. Some pitfalls to watch out for are:

1) If earnings are intended to be retained in the corporation for growth and the corporate income tax rate would be less than the individual shareholders' rates, election should be postponed until the corporation is ready to begin regular distributions of earnings.

2) A corporate loss in excess of basis may be lost forever if no action is taken to increase shareholder's basis.

3) Capital losses can be used only to reduce corporate capital gains.
4) Tax preference income passes through to each stockholder in proportion to his stock interest in the business.

5) Because of restrictions on the sources of income, care must be taken so that the election will not be lost.

CONCLUSION

The Senate Finance Committee Report accompanying Subchapter S—which was a Senate amendment—gave several reasons for its adoption.

Your committee believes that the enactment of a provision of this type is desirable because it permits businesses to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence. In this respect, a provision to tax the income at the shareholder, rather than the corporate level, will complement the provision enacted in 1954 permitting proprietorships and partnerships to be taxed like corporations. Also, permitting shareholders to report their proportionate share of the corporate income, in lieu of a corporate tax, will be a substantial aid to small business. It will be primarily beneficial to those individuals who have marginal tax rates below the 52 per cent corporate rate (or 30 per cent rate in the case of the smaller corporations) where the earnings are left in the business. Where the earnings are distributed (and are in excess of what may properly be classified as salary payments), the benefit will extend to individuals with somewhat higher rates since in this case a "double" tax is removed. The provision will also be of substantial benefit to small corporations realizing losses.
for a period of years where there is no way of offsetting these losses against taxable income at the corporate level, but the shareholders involved have other income which can be offset against these losses. In this connection it should be noted that the President's Cabinet Committee on Small Business and the President in his budget message this last January recommended a general provision of this type for the benefit of small business.
NOTES


10. Ibid., p. 259.

11. Seago, p. 158.


13. Seago, p. 156.

A more detailed explanation is available in Bittker and Eustice's *Federal Income Taxation of Corporations and Shareholders*, pages 6-15 through 6-17.


If there is a net operating loss this requirement is always met.


Ibid., p. 20-19. A graphic presentation and further discussion of the determination of the amount of tax is contained in the Crumley, Davis, and Welker article.

Hoffman, p. 336.

As defined by Bittker and Eustice, the adjusted basis of the shareholder's investment is determined as of the close of the corporation's taxable year, unless he disposed of some or all of his stock during the year. P. 6-26.

Ibid., p. 6-25.


Hoffman, p. 330.

Bittker and Eustice, p. 6-17.

Ibid., p. 330. Two examples are provided to clarify any doubts.

Bittker and Eustice, p. 6-30.

See Hoffman's pages 330-334 for an in depth discussion of cash and property distributions.
31 Bittker and Eustice, p. 6-34. There is a discussion of collateral tax advantages of the Subchapter S election, which is somewhat specific in relation to the content of this paper.

BIBLIOGRAPHY


GLOSSARY OF TERMS

Basis - The amount of capital contributed, with adjustments for withdrawals, income, and losses.

Calendar year - Twelve consecutive months ending on December 31.

Capital gain - Gain on the sale of a capital asset.

Code - Term referring to the Internal Revenue Code.

Electing corporation - Corporation which meets the six qualifying requirements and has followed the Internal Revenue Service's guidelines in choosing to be taxed under Subchapter S provisions.

Fiscal year - Either twelve consecutive months ending on the last day of any month other than December, or a 52-53 week year.

Internal Revenue Service (IRS) - Government agency regulating taxes and filing procedures.

Minimum tax - A tax which is imposed on tax preference items.

Net long-term capital gain - The excess of long-term capital gains over short-term losses.

Net operating loss - The excess of allowable deductions over gross income after certain adjustments are applied to that excess.

Previously taxed income (PTI) - The accumulated taxable income which is not paid as cash dividends during the accounting period or within the two and one-half month "grace" period immediately following the period.

Section - Term referring to a rule of the Internal Revenue Code.

Subchapter S - Corporation which elects to have its income taxed directly to shareholders.

Tax preference items - Items subject to a possible minimum tax. These include excess itemized deductions, accelerated depreciation on real property or leased personal property, excess amortization, bad debt deductions of financial
institutions, depletion, capital gains, and intangible drilling costs.

**Taxable income** - The dollar figure subject to the appropriate income tax rates.

**Undistributed taxable income (UTI)** - The amount of taxable income allocated to shareholders of Subchapter S corporations which is not paid in cash as dividends to shareholders during the current accounting period or two and one-half month "grace" period.
1120S   U. S. Small Business Corporation Income Tax Return

2553   Election by Small Business Corporation

7004   Application for Automatic Extension of Time to File Corporation Income Tax Return
**U.S. Small Business Corporation Income Tax Return**

**for calendar year 1977 or**

Other taxable year beginning ________________________, 1977, ending ________________________, 19_____

**A Date of election as small business corporation**

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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Gross receipts or gross sales</td>
<td>Less: Returns and allowances</td>
</tr>
<tr>
<td>2</td>
<td>Less: Cost of goods sold (Schedule A) and/or operations (attach schedule)</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Gross profit</td>
<td></td>
</tr>
<tr>
<td>4(a)</td>
<td>Domestic dividends</td>
<td></td>
</tr>
<tr>
<td>4(b)</td>
<td>Foreign dividends</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Interest on obligations of the U.S. and U.S. instrumentalities</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Other interest</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Gross rents</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Gross royalties</td>
<td></td>
</tr>
<tr>
<td>9(a)</td>
<td>Net short-term capital gain reduced by any net long-term capital loss</td>
<td></td>
</tr>
<tr>
<td>9(b)</td>
<td>Net capital gain (if more than $25,000, see instructions)</td>
<td></td>
</tr>
<tr>
<td>9(c)</td>
<td>Ordinary gain or (loss) from Part II, Form 4797</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Other income (see instructions—attach schedule)</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>TOTAL income—Add lines 3 through 10</td>
<td></td>
</tr>
</tbody>
</table>

**B Business Code No. (see page 7 of instructions)**

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Use IRS label, otherwise, print, or type:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Name</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Number and street</td>
<td></td>
</tr>
<tr>
<td></td>
<td>City or town, State, and ZIP code</td>
<td></td>
</tr>
</tbody>
</table>

**C Employer identification no.**

**D Date incorporated**

**E Enter total assets from line 14, column (D), Schedule L (See instruction N)**

**IMPORTANT—All applicable lines and schedules must be filled in. If the lines on the schedules are not sufficient, see instruction N.**

Note: If section 465 (deductions limited to amount at-risk) applies, see instruction for line 28.

**GROSS INCOME**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>Compensation of officers (Schedule E)</td>
</tr>
<tr>
<td>13</td>
<td>Salaries and wages (not deducted elsewhere)</td>
</tr>
<tr>
<td>14</td>
<td>Repairs (see instructions)</td>
</tr>
<tr>
<td>15</td>
<td>Bad debts (Schedule F if reserve method is used)</td>
</tr>
<tr>
<td>16</td>
<td>Rents</td>
</tr>
<tr>
<td>17</td>
<td>Taxes (attach schedule)</td>
</tr>
<tr>
<td>18</td>
<td>Interest</td>
</tr>
<tr>
<td>19</td>
<td>Contributions (not over 5% of line 28 adjusted per instructions—attach schedule)</td>
</tr>
<tr>
<td>20</td>
<td>Amortization (attach schedule)</td>
</tr>
<tr>
<td>21</td>
<td>Depreciation from Form 4562 (attach Form 4562), less depreciation claimed in Schedule A and elsewhere on return, Balance</td>
</tr>
<tr>
<td>22</td>
<td>Depletion (attach schedule)</td>
</tr>
<tr>
<td>23</td>
<td>Advertising</td>
</tr>
<tr>
<td>24</td>
<td>Pension, profit-sharing, etc. plans (see instructions) (enter number of plans)</td>
</tr>
<tr>
<td>25</td>
<td>Employee benefit programs (see instructions)</td>
</tr>
<tr>
<td>26</td>
<td>Other deductions (attach schedule)</td>
</tr>
<tr>
<td>27</td>
<td>TOTAL deductions—Add lines 12 through 26</td>
</tr>
<tr>
<td>28</td>
<td>Taxable income (line 11 less line 27) (see instructions)</td>
</tr>
</tbody>
</table>

**DEDUCTIONS**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>29</td>
<td>Income tax on capital gains (Schedule J)</td>
</tr>
<tr>
<td>30</td>
<td>Minimum tax (see instructions—attach Form 4626)</td>
</tr>
<tr>
<td>31</td>
<td>Total tax (add lines 29 and 30)</td>
</tr>
<tr>
<td>32(a)</td>
<td>Tax deposited with Form 7004 (attach copy)</td>
</tr>
<tr>
<td>32(b)</td>
<td>Tax deposited with Form 7005 (attach copy)</td>
</tr>
<tr>
<td>32(c)</td>
<td>Credit for U.S. tax on special fuels, nonhighway gas, and lubricating oil (attach Form 4136)</td>
</tr>
<tr>
<td>33</td>
<td>TAX DUE (line 31 less line 32). See instruction G for depositary method of payment</td>
</tr>
<tr>
<td>34</td>
<td>OVERPAYMENT (line 32 less line 31)</td>
</tr>
</tbody>
</table>

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

**Signature of officer**

**Date**

**Paid preparer’s signature and identifying number (see Instructions)**

**Title**

**Paid preparer’s address (or employer’s name, address, and identifying number)**
### Schedule A  Cost of Goods Sold (See instruction 2)

1. Inventory at beginning of year  
2. Merchandise bought for manufacture or sale  
3. Salaries and wages  
4. Other costs (attach schedule)  
5. Total of lines 1 through 4  
6. Less: Inventory at end of year  
7. Cost of goods sold—Enter here and on line 2, page 1  
8. (a) Check valuation method(s) used for total closing inventory:  
   - Cost  
   - Lower of cost or market  
   - Other (attach explanation)  
8. (b) Check if this is the first year LIFO inventory method was adopted and used. If checked, attach Form 970.  
8. (c) If the LIFO inventory method was used for this taxable year, enter percentage (or amounts) of closing inventory computed under LIFO.  
8. (d) If you are a manufacturer, check if you valued your inventory in accordance with section 1.471-11 of the regulations.  
8. (e) Was there any substantial change in determining quantities, cost, or valuations between opening and closing inventory? Yes  No  

### Schedule E  Compensation of Officers (See instruction 12)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
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<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Total compensation of officers—Enter here and on line 12, page 1.

### Schedule F  Bad Debts—Reserve Method (See instruction 15)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1972</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1973</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1974</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1975</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1976</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1977</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Schedule J  Tax Computation (See instructions)

1. Taxable income (line 28, page 1)  
2. Enter $25,000. (Members of a controlled group, see instructions)  
3. Line 1 less line 2  
4. Enter line 3 or $25,000, whichever is lesser. (Members of a controlled group, see instructions)  
5. Line 3 less line 4  
6. Enter 20% of line 2  
7. Enter 25% of line 4  
8. Enter 48% of line 5  
9. Add lines 6, 7, and 8  
10. Net capital gain (from line 9(b), page 1)  
11. Subtract $25,000. (Statutory minimum)  
12. Balance (line 10 less line 11). (See instructions)  
13. Enter 30% of line 12. (See instructions)  
14. Income tax on capital gains (line 9 or line 13, whichever is lesser). Enter here and on line 29, page 1. $25,000.00
## Form 1120S (1977) Page 3

### Schedule K: Computation of Undistributed Taxable Income and Summary of Distributions and Other Items

#### Computation of Corporation's Undistributed Taxable Income

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Taxable income (line 28, page 1)</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Less: (a) Money distributed as dividends out of earnings and profits of the taxable year</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(b) Tax imposed on certain capital gains (line 31, page 1)</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Corporation's undistributed taxable income</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Actual dividend distributions taxable as ordinary income. (Do not include amounts shown on line 6)</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Actual dividend distributions taxable as long-term capital gains (after tax)</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Actual dividend distributions taxable as ordinary income and qualifying for dividend exclusion</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Nondividend distributions</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Undistributed taxable income—taxable as ordinary income or (loss)</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Undistributed taxable income—taxable as long-term capital gain (after tax)</td>
<td></td>
</tr>
</tbody>
</table>

#### 10 Investment credit property

<table>
<thead>
<tr>
<th>Property for Investment Credit</th>
<th>Basis of new investment property</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(a) 3 or more but less than 5 years</td>
</tr>
<tr>
<td></td>
<td>(b) 5 or more but less than 7 years</td>
</tr>
<tr>
<td></td>
<td>(c) 7 or more years</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Qualified progress expenditures</th>
<th>1974, 1975 and 1976</th>
<th>(d) 7 or more years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of used investment property</td>
<td>(f) 3 or more but less than 5 years</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(g) 5 or more but less than 7 years</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(h) 7 or more years</td>
<td></td>
</tr>
</tbody>
</table>

#### 11 Interest on investment indebtedness:

- (a) (1) Interest on investment indebtedness incurred prior to December 17, 1969.
- (2) Interest on investment indebtedness incurred prior to September 11, 1975, but after December 16, 1969.
- (3) Interest on investment indebtedness incurred after September 10, 1975.
- (b) Net investment income or (loss).
- (c) Excess expenses from "net lease property".
- (d) Net capital gain attributable to investment property.

#### 12 Item of tax preference (see instructions):

- (a) Accelerated depreciation on—
  - (1) Low income rental housing.
  - (2) Other real property.
  - (3) Personal property subject to a lease.
- (b) Amortization:
  - (1) ...,
  - (2) ...,
  - (3) ...,
  - (4) ...
- (c) Reserve for losses on bad debts of financial institutions.
- (d) Depletion.
- (e) Intangible drilling costs.
- (f) Net capital gain (after tax).

#### 13 New jobs credit (see instructions).

### Additional Information Required

- **F** Did you at the end of the taxable year own, directly or indirectly, 50% or more of the voting stock of a domestic corporation? **Yes** | **No**
- **G** Taxable income (loss) from line 28, Page 1, Form 1120S for your taxable year beginning in: 1974: 1975: 1976:
- **H** Refer to page 7 of instructions and state the principal:
  - Business activity:
    - Product or service:
- **I** WERE you a member of a controlled group subject to the provisions of section 1561? **Yes** | **No**
- **J** Did you claim a deduction for expenses connected with:
  - (1) Entertainment facility (boat, resort, ranch, etc.)?
  - (2) Living accommodations (except for employees on business)?
  - (3) Employees' families at conventions or meetings?
  - (4) Employee or family vacations not reported on Form W-2?
- **K** Did you file all required Forms 1087, 1096, and 1099? **Yes** | **No**
- **L** Answer only if (1) this is the first 1120S return filed since your election to be treated as a small business corporation and (2) the corporation was in existence for the taxable year prior to the election and had investment credit property: Was an agreement filed under section 1.47-4(b) of the regulations? **Yes** | **No**
- **M** Did you, at any time during the taxable year, have any interest in or signature or other authority over a bank, securities, or other financial account in a foreign country (except in a U.S. military banking facility operated by a U.S. financial institution)? If "Yes," see Instruction R.
- **N** Were you the grantor of, or transferor to, a foreign trust during any taxable year, which foreign trust was in being during the current taxable year, whether or not you have any beneficial interest in such trust? If "Yes," you may be required to file forms 3520, 3520-A, or 926.
- **O** Was this firm in business at the end of 1977? **Yes** | **No**
- **P** How many months in 1977 was this firm in business? **Yes** | **No**

Enter total amount of deduction(s) on Form 1120S that are claimed under section 274 (entertainment, gifts, etc.)

**K** Did you file all required Forms 1087, 1096, and 1099?

**L** Answer only if (1) this is the first 1120S return filed since your election to be treated as a small business corporation and (2) the corporation was in existence for the taxable year prior to the election and had investment credit property: Was an agreement filed under section 1.47-4(b) of the regulations?

**M** Did you, at any time during the taxable year, have any interest in or signature or other authority over a bank, securities, or other financial account in a foreign country (except in a U.S. military banking facility operated by a U.S. financial institution)? If "Yes," see Instruction R.

**N** Were you the grantor of, or transferor to, a foreign trust during any taxable year, which foreign trust was in being during the current taxable year, whether or not you have any beneficial interest in such trust? If "Yes," you may be required to file forms 3520, 3520-A, or 926.

**O** Was this firm in business at the end of 1977?

**P** How many months in 1977 was this firm in business?
### Schedule L: Balance Sheets

#### Assets

<table>
<thead>
<tr>
<th>Item</th>
<th>Beginning of Taxable Year</th>
<th>End of Taxable Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Cash</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Trade notes and accounts receivable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Less allowances for bad debts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Inventories</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4 Gov't obligations: (a) U.S. and instrumentalities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) State, subdivisions thereof, etc.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5 Other current assets (attach schedule)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 Loans to shareholders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7 Mortgage and real estate loans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8 Other investments (attach schedule)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9 Buildings and other fixed depreciable assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Less accumulated depreciation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10 Depletable assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Less accumulated depletion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11 Land (net of any amortization)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12 Intangible assets (amortizable only)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Less accumulated amortization</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13 Other assets (attach schedule)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>14 Total assets</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Liabilities and Shareholders' Equity

<table>
<thead>
<tr>
<th>Item</th>
<th>Beginning of Taxable Year</th>
<th>End of Taxable Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>15 Accounts payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>16 Mtges., notes, bonds payable in less than 1 year</td>
<td></td>
<td></td>
</tr>
<tr>
<td>17 Other current liabilities (attach schedule)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>18 Loans from shareholders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>19 Mtges., notes, bonds payable in 1 year or more</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20' Other liabilities (attach schedule)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>21 Capital stock</td>
<td></td>
<td></td>
</tr>
<tr>
<td>22 Paid-in or capital surplus</td>
<td></td>
<td></td>
</tr>
<tr>
<td>23 Retained earnings—appropriated (attach schedule)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>24 Retained earnings—unappropriated</td>
<td></td>
<td></td>
</tr>
<tr>
<td>25 Shareholders' undistributed taxable income previously taxed</td>
<td></td>
<td></td>
</tr>
<tr>
<td>26 Less cost of treasury stock</td>
<td></td>
<td></td>
</tr>
<tr>
<td>27 Total liabilities and shareholders' equity</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Schedule M-1: Reconciliation of Income Per Books With Income Per Return

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Net income per books</td>
<td></td>
</tr>
<tr>
<td>2 Federal income tax</td>
<td></td>
</tr>
<tr>
<td>3 Excess of capital losses over capital gains</td>
<td></td>
</tr>
<tr>
<td>4 Income subject to tax not recorded on books this year (itemize)</td>
<td></td>
</tr>
<tr>
<td>5 Expenses recorded on books this year not deducted in this return (itemize)</td>
<td></td>
</tr>
<tr>
<td>6 Total of lines 1 through 5</td>
<td></td>
</tr>
<tr>
<td>7 Income recorded on books this year not included in this return (itemize)</td>
<td></td>
</tr>
<tr>
<td>(a) Tax-exempt interest</td>
<td></td>
</tr>
<tr>
<td>8 Deductions in this tax return not charged against book income this year (itemize)</td>
<td></td>
</tr>
<tr>
<td>9 Total of lines 7 and 8</td>
<td></td>
</tr>
<tr>
<td>10 Income (line 28, page 1)—line 6 less line 9</td>
<td></td>
</tr>
</tbody>
</table>

### Schedule M-2: Analysis of Unappropriated Retained Earnings Per Books (line 24 above)

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Balance at beginning of year</td>
<td></td>
</tr>
<tr>
<td>2 Net income per books</td>
<td></td>
</tr>
<tr>
<td>3 Other increases (itemize)</td>
<td></td>
</tr>
<tr>
<td>4 Total of lines 1, 2, and 3</td>
<td></td>
</tr>
<tr>
<td>5 Distributions out of current or accumulated earnings and profits: (a) Cash</td>
<td></td>
</tr>
<tr>
<td>(b) Stock</td>
<td></td>
</tr>
<tr>
<td>(c) Property</td>
<td></td>
</tr>
<tr>
<td>6 Current year's undistributed taxable income or net operating loss (total of lines 8 and 9, Schedule K)</td>
<td></td>
</tr>
<tr>
<td>7 Other decreases (itemize)</td>
<td></td>
</tr>
<tr>
<td>8 Total of lines 5, 6, and 7</td>
<td></td>
</tr>
<tr>
<td>9 Balance at end of year (line 4 less line 8)</td>
<td></td>
</tr>
</tbody>
</table>
**Part I** Short-term Capital Gains and Losses—Assets Held 9 Months or Less

<table>
<thead>
<tr>
<th>a. Kind of property and description (Example, 100 shares of &quot;Z&quot; Co.)</th>
<th>b. Date acquired (mo., day, yr.)</th>
<th>c. Date sold (mo., day, yr.)</th>
<th>d. Gross sales price</th>
<th>e. Cost or other basis and expense of sale</th>
<th>f. Gain or (loss) (d less e)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>2 Unused capital loss carryover (attach computation)</td>
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</tr>
<tr>
<td>3 Net short-term capital gain or (loss) (combine lines 1 and 2, column f)</td>
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</tr>
</tbody>
</table>

**Part II** Long-term Capital Gains and Losses—Assets Held More Than 9 Months

<table>
<thead>
<tr>
<th>4 Enter section 1231 gain from line 4(a)(1), Form 4797</th>
<th></th>
<th></th>
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<td>5</td>
<td></td>
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<tr>
<td>6 Net long-term capital gain or (loss) (combine lines 4 and 5, column f)</td>
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</tbody>
</table>

**Part III** Summary of Schedule D Gains and Losses

| 7 Excess of net short-term capital gain (line 3) over net long-term capital loss (line 6). Enter here and on line 9(a), page 1, Form 1120S |   |   |   |   |   |
| 8 Excess of net long-term capital gain (line 6) over net short-term capital loss (line 3). Enter here and on line 9(b), page 1, Form 1120S |   |   |   |   |   |

**Instructions**

*References are to the Internal Revenue Code.*

This schedule provides for the reporting of sales or exchanges of capital assets. Every sale or exchange of property must be reported even though no gain or loss is indicated.

See Form 4797 and related instructions for reporting sales or exchanges of property other than capital assets including the sale or exchange of property used in the trade or business and involuntary conversions (section 1231), also, gain from the disposition of interest in oil and gas property (section 1254).

**Note:** The Tax Reform Act of 1976 increased the holding period for long-term capital gains and losses from more than 6 months to more than 9 months for taxable years beginning in 1977 and more than one year for taxable years beginning in 1978 and thereafter.

In the case of amounts received from an installment sale, the holding period rule in effect in the year of sale will determine the treatment of the amounts received as long-term or short-term gain.

Gains and losses on futures transactions (but not options on futures transactions) in any agricultural commodity subject to the rules of a board of trade or commodity exchange will retain the more than 6-month holding period rule for long-term treatment. See section 1222.

**Capital Assets.—** Each item of property held by the corporation (whether or not connected with its trade or business) is a capital asset except: (1) inventorable assets or property held primarily for sale to customers; (2) depreciable or real property used in the trade or business; (3) certain copyrights, literary, musical, or artistic compositions, letters or memo-
Gain from Sale of Depreciable Property Between Certain Related Taxpayers.—Gain from the sale or exchange of depreciable property between related persons is ordinary income if such property is, in the hands of the transferee, subject to depreciation. "Related persons" includes: (1) an individual and a corporation 80 percent or more in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual; or (2) two or more corporations 80 percent or more in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual. In general, section 318 applies with respect to the constructive ownership of stock. Item (2) only applies to sales or exchanges made after October 4, 1976, unless the sale or exchange was made pursuant to a binding contract entered into on or before that date. (See section 1239.)

Capital Losses.—Capital losses are allowed only to the extent of capital gains. A net capital loss, however, may be carried forward as a short-term capital loss for 5 years (10 years to the extent the loss is attributable to a foreign expropriation loss) or until exhausted, whichever comes first.

Short Sales of Capital Assets.—For rules relating to certain short sales of stock or other securities and transactions in commodity futures, see section 1233.

Worthless Securities.—Except for banks, if securities that are capital assets become wholly worthless during the taxable year, the loss is to be treated as a capital loss as of the last day of the taxable year.

Losses Not Allowable.—No loss is allowed for wash sales of stock or securities. (See section 1091.) No loss is allowed (distributions in liquidation excepted) on transactions between related persons. (See section 267.)

Options to Buy or Sell.—See section 1234 for rules pertaining to the treatment of gain or loss in the case of a purchaser or that of a grantor of an option in the case of stock, securities, or commodities granted after September 1, 1976.

Costs or Other Basis, As Adjusted.—In determining gain or loss, the basis of property will generally be its cost. If property was acquired by bequest, gift, tax-free exchange, involuntary conversion, or wash sale of stock, see sections 1014 and 1023, 1015, 1031, 1033, and 1091, respectively. Attach an explanation if the basis used is other than actual cash cost of the property.

If a charitable contribution deduction is allowed by reason of a sale of property to a charitable organization, the adjusted basis for determining gain from the sale is an amount that is in the same ratio to the adjusted basis as the amount realized is to the fair market value of the property.

Minimum Tax on Tax Preference Items.—If the net long-term capital gain exceeds the net short-term capital loss, you may be liable for minimum tax. See Form 4626.

Installment Sales.—If you sold personal property for more than $1,000 or real property regardless of amount, you may be eligible to report any gain under the installment method if (1) there are no payments in the year of sale or (2) the payments in the year of sale do not exceed 30% of the selling price. (See section 453.) Such sales must provide for two or more payments, with at least one payment being made in each of two taxable years.

For treatment of a portion of payments as "unstated interest" on deferred payment sales, see section 483.
### Shareholder's Share of Undistributed Taxable Income, etc.—1977

**Form 1120S**  
For calendar year 1977 or other taxable year

#### Part I Income

1. Undistributed taxable income—ordinary income or (loss)  
2. Undistributed taxable income—long-term capital gain after tax

#### Part II Losses from Section 465 Activities

1. Shareholder's distributive share of losses from section 465 activities (see instructions)

#### Part III Interest on Investment Indebtedness

1(a) Interest on investment indebtedness incurred prior to December 17, 1969  
1(b) Interest on investment indebtedness incurred prior to September 11, 1975, but after December 16, 1969  
1(c) Interest on investment indebtedness incurred after September 10, 1975  
2. Net investment income or (loss)  
3. Excess expenses from "net lease property"  
4. Net capital gain attributable to investment property

#### Part IV Items of Tax Preference (See Instructions)

1. Accelerated depreciation on:  
   (a) Low income rental housing  
   (b) Other real property  
   (c) Personal property subject to a lease  
2. Amortization:  
   (a)  
   (b)  
   (c)  
   (d)  
3. Reserves for losses on bad debts of financial institutions  
4. Depletion  
5. Intangible drilling costs  
6. Net capital gain (after tax)

#### Part V Property Eligible for Investment Credit

- Basis of new investment property:  
  (a) 3 or more but less than 5 years  
  (b) 5 or more but less than 7 years  
  (c) 7 or more years  
- Qualified progress expenditures:  
  1974, 1975, and 1976  
  1977  
- Cost of used investment property:  
  (f) 3 or more but less than 5 years  
  (g) 5 or more but less than 7 years  
  (h) 7 or more years

#### Part VI Property Used in Recomputing a Prior Year Investment Credit

1. Description of property  
2. Date placed in service  
3. Cost or basis

#### Part VII New Jobs Credit

1. Shareholder's distributive share of new jobs credit

#### Part VIII Other Shareholder Information

- Name and address of shareholder  
- Social security number  
- Number of shares  
- Period held  
- Date acquired  
- Date of disposition  
- Corporation's name, identifying number, and address (including ZIP code)
**Schedule K-1 (Form 11205)**

**Shareholder’s Share of Undistributed Taxable Income, etc.—1977**

For calendar year 1977 or other taxable year beginning ____________________________, 1977, ending ____________________________.

**Part I: Income**

<table>
<thead>
<tr>
<th>(a) Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Undistributed taxable income—ordinary income or (loss)</td>
</tr>
<tr>
<td>2. Undistributed taxable income—long-term capital gain after tax</td>
</tr>
</tbody>
</table>

**Part II: Losses from Section 465 Activities**

<table>
<thead>
<tr>
<th>(a) Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Shareholder’s distributive share of losses from section 465 activities (see instructions)</td>
</tr>
</tbody>
</table>

**Part III: Interest on Investment Indebtedness**

<table>
<thead>
<tr>
<th>(a) Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1(a) Interest on investment indebtedness incurred prior to December 17, 1969</td>
</tr>
<tr>
<td>1(b) Interest on investment indebtedness incurred prior to September 11, 1975, but after December 16, 1969</td>
</tr>
<tr>
<td>1(c) Interest on investment indebtedness incurred after September 10, 1975</td>
</tr>
<tr>
<td>2. Net investment income or (loss)</td>
</tr>
<tr>
<td>3. Excess expenses from “net lease property”</td>
</tr>
<tr>
<td>4. Net capital gain attributable to investment property</td>
</tr>
</tbody>
</table>

**Part IV: Items of Tax Preference (See Instructions)**

<table>
<thead>
<tr>
<th>(a) Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Accelerated depreciation on: (a) Low income rental housing</td>
</tr>
<tr>
<td>(b) Other real property</td>
</tr>
<tr>
<td>(c) Personal property subject to a lease</td>
</tr>
<tr>
<td>2. Amortization: (a)</td>
</tr>
<tr>
<td>(b)</td>
</tr>
<tr>
<td>(c)</td>
</tr>
<tr>
<td>(d)</td>
</tr>
<tr>
<td>3. Reserves for losses on bad debts of financial institutions</td>
</tr>
<tr>
<td>4. Depletion</td>
</tr>
<tr>
<td>5. Intangible drilling costs</td>
</tr>
<tr>
<td>6. Net capital gain (after tax)</td>
</tr>
</tbody>
</table>

**Part V: Property Eligible for Investment Credit**

| (a) | 3 or more but less than 5 years |  |
| (b) | 5 or more but less than 7 years |  |
| (c) | 7 or more years |  |
| (d) | 7 or more years |  |

**Part VI: Property Used in Recomputing a Prior Year Investment Credit**

| Column numbers and headings correspond to those on Form 4255 |

**Part VII: New Jobs Credit**

<table>
<thead>
<tr>
<th>(a) Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Shareholder’s distributive share of new jobs credit</td>
</tr>
</tbody>
</table>

**Part VIII: Other Shareholder Information**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>1. Name and address of shareholder</td>
<td></td>
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<tr>
<td>2. Social security number</td>
<td></td>
</tr>
<tr>
<td>3. Stock ownership</td>
<td></td>
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<tr>
<td>Number of shares</td>
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<tr>
<td>Date acquired</td>
<td></td>
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<tr>
<td>Date of disposition</td>
<td></td>
</tr>
</tbody>
</table>

Corporation's name, identifying number, and address (including ZIP code)
Instructions for Shareholder

(References are to the Internal Revenue Code.)

A. General instructions.—Copy B of Schedule K-1 (Form 1120S) should help you when you prepare your income tax return. It shows your pro rata share of: (1) undistributed taxable income or loss, section 465 activity loss(es), items of tax preference, items used to compute the limitation on the deferral of different items of tax preference, items used to compute the limitation on the deferral of different items of tax preference

Keep it for your records and do NOT file it with your tax return. The original has been filed by the corporation with the Internal Revenue Service.

This schedule does NOT report the amount of actual dividend distributions paid to you by the corporation. Such amounts aggregating $10 or more during the calendar year should be reported by the corporation on Form 1099-DIV.

B. Part I, losses from section 465 activities.—The entry of section 465 losses in Part I is for information purposes only. Section 465 losses are stated separately to allow you in determining the amount of each section 465 activity loss you may deduct on your individual tax return. If a section 465 activity loss exceeds the amount you are "at-risk" for such activity, an explanation of adjustments to the adjusted basis limitation and the "at-risk" factor limitation is given below.

If you claim a deduction for a net operating loss, attach to your tax return a computation of the adjusted basis of your stock in the corporation and the adjusted basis of any indebtedness of the corporation to you.

Under section 1374(c)(2), the amount of loss you can deduct on your return under section 1374(c)(1), is limited to the sum of:

1. The adjusted basis of your stock in the corporation and
2. The amount of any indebtedness of the corporation to you.

If your pro rata share of such loss exceeds the section 1374(c)(2) limitation described above, the excess cannot be deducted.

Effective for taxable years beginning after 1975, special "at-risk" rules apply in the case of a small business corporation engaged in the activity of:

1. Holding, producing, or distributing motion picture films or video tapes,
2. Farming (as defined in section 464(e)),
3. Leasing any section 1245 property,
4. Exploring for, or exploiting, oil and gas resources.

Your share of any corporate loss from any of the above activities for the taxable year is allowed only to the extent of the aggregate amount with respect to which you are "at-risk" with respect to the activity at the close of the corporation's taxable year.

You are generally considered to be "at-risk" with respect to an activity to the extent of the cash and the adjusted basis of other property you contributed to the activity or acquired for use in the activity for which you are either personally liable or have pledged property as security (other than property held in inventory under section 1366(b)) or for exclusions and exceptions to the above general rule and section 204(c)(2) and (3) of the Tax Reform Act of 1976 for special transitional rules concerning movies and video tapes and leasing activities.

Your proportionate share in the corporation is treated as a single activity to the extent it is engaged in activities described in any one of items (1) through (4) above. For example, if the corporation is engaged in the operation of a drilling rig, the sections of section 664(e)), the two operations are considered a single activity for purposes of determining the amount at which you are "at-risk." However, if the corporation is engaged in two (or more) different types of the "at-risk" activities, you are considered to be engaged in two (or more) separate activities and you must make a separate computation of the amount you are "at-risk" for each separate activity.

If the corporation is engaged in two (or more) different types of "at-risk" activities or any combination of "at-risk" activities and other than "at-risk," any loss from each "at-risk" activity will be identified in Part II so you can determine the amount of any such loss(es) you are entitled to deduct on your return for the taxable year.

If any portion of your distributive share of a section 465 activity loss was disallowed for any year because any portion of the section 465 limitations, such portion shall be treated as a deduction allocable to such activity in your 1977 taxable year.

(See section 1374 and the related regulations and section 465.)

D. Part II, losses from section 465 activities.—The entry of section 465 losses in Part II is for information purposes only. Section 465 losses are stated separately to allow you in determining the amount of each section 465 activity loss you may deduct on your individual tax return. If a section 465 activity loss exceeds the amount you are "at-risk" for such activity, then the gain or loss on line 1, Part I, which contains the section 465 activity loss, must be adjusted by you for the amount the section 465 activity loss exceeds the amount you are "at-risk" for such activity.

E. Repayment of indebtedness with a reduced basis.—If net operating losses in prior years exceed the adjusted basis of your stock in the corporation and have been applied to decrease the adjusted basis of your loans to the corporation in prior years, any repayments of such loans in this year will result in taxable income to you to the extent that the repayments exceed the adjusted basis of the loan. Whether the income is reportable as capital gain or ordinary income by you will depend on the nature of the indebtedness.

If the loan is repaid in installments, a breakdown of each payment must be made to show the computation of (1) return of capital and (2) income. (Revenue Ruling 64-3, 1964-1 (Part 1) C.B. 304 and Revenue Ruling 68-537, 1968-2 C.B. 372.)

(See section 1376 and the related regulations.)

F. Part IV, items of tax preference.—Your share of the total amortization deducted by the corporation is listed in the amount column of line 2, Part IV. The dollar amount of each specific type of amortization contained in this amount is listed in the expense column of line 2, Part IV. The order in which the following entries are entered is as follows:

(a) certified pollution control facilities,
(b) railroad rolling stock,
(c) on-the-job training facilities,
(d) child care facilities.

Line 5 contains your distributive share of the corporation's intangible drilling costs, itemized tax preference for all other oil and gas well properties in which you have an interest. This amount is to be entered on the appropriate line of Form 4625 (Form 4626 for estates and trusts).

Line 5 contains your distributive share of the corporation's intangible drilling costs, itemized tax preference for all other oil and gas well properties in which you have an interest. This amount is to be entered on the appropriate line of Form 4625 (Form 4626 for estates and trusts). See the instructions for Forms 4625 and 4626 for other details.
<table>
<thead>
<tr>
<th>Part</th>
<th>Description</th>
<th>Formula</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>I.</td>
<td>Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1. Undistributed taxable income—ordinary income or (loss)</td>
<td>(a) Amount</td>
<td>Sch. E, Part III</td>
</tr>
<tr>
<td></td>
<td>2. Undistributed taxable income—long-term capital gain after tax</td>
<td>(a) Amount</td>
<td>Sch. D, Part II</td>
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<tr>
<td>II.</td>
<td>Losses from Section 465 Activities</td>
<td></td>
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<tr>
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<td>1. Shareholder's distributive share of losses from section 465 activities (see instructions)</td>
<td></td>
<td>Form 4952 line reference</td>
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<td>III.</td>
<td>Interest on Investment Indebtedness</td>
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<tr>
<td></td>
<td>1(a) Interest on investment indebtedness incurred prior to December 17, 1969</td>
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<td>Form 4625 line reference</td>
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<tr>
<td></td>
<td>1(b) Interest on investment indebtedness incurred prior to September 11, 1975, but after December 16, 1969</td>
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<td>1(c) Interest on investment indebtedness incurred after September 10, 1975</td>
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<td>2. Net investment income or (loss)</td>
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<td>3. Excess expenses from &quot;net lease property&quot;</td>
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<td>4. Net capital gain attributable to investment property</td>
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<td>IV.</td>
<td>Items of Tax Preference (See Instructions)</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>1. Accelerated depreciation on:</td>
<td></td>
<td>Form 3468 line reference</td>
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<tr>
<td></td>
<td>(a) Low income rental housing</td>
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<td></td>
<td>(b) Other real property</td>
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<td>(c) Personal property subject to a lease</td>
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<td>2. Amortization:</td>
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<td>5. Intangible drilling costs</td>
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<td>6. Net capital gain (after tax)</td>
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<td>V.</td>
<td>Property Eligible for Investment Credit</td>
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<tr>
<td></td>
<td>Basis of new investment property</td>
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<td>Column numbers and headings correspond to those on Form 4255</td>
</tr>
<tr>
<td></td>
<td>(a) 3 or more but less than 5 years</td>
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<td>(b) 5 or more but less than 7 years</td>
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<td>(c) 7 or more years</td>
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<td></td>
<td>Qualified progress expenditures</td>
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<td>1974, 1975, and 1976</td>
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<td>1977</td>
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<td>(d) 7 or more years</td>
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<td>(e) 7 or more years</td>
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<td></td>
<td>Cost of used investment property</td>
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<td>(f) 3 or more but less than 5 years</td>
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<td>(g) 5 or more but less than 7 years</td>
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<td>(h) 7 or more years</td>
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<tr>
<td>VI.</td>
<td>Property Used in Recomputing a Prior Year Investment Credit</td>
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<tr>
<td></td>
<td>(1) Description of property</td>
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<td></td>
<td>(2) Date placed in service</td>
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<td>(3) Cost or basis</td>
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<td></td>
<td>(4) Estimated useful life</td>
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<td>(5) Applicable percentage</td>
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<td>(6) Original qualified investment (Col. 3 x col. 5)</td>
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<td></td>
<td>(7) Date item ceased to be in-vestment credit property</td>
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<tr>
<td></td>
<td>(8) Actual useful life</td>
<td></td>
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<tr>
<td></td>
<td>(9) Applicable percentage (Col. 3 x col. 10)</td>
<td></td>
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<tr>
<td>VII.</td>
<td>New Jobs Credit</td>
<td></td>
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</tr>
<tr>
<td></td>
<td>1. Shareholder's distributive share of new jobs credit</td>
<td></td>
<td>Form 5884 line reference</td>
</tr>
<tr>
<td>VIII.</td>
<td>Other Shareholder Information</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1. Name and address of shareholder</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>2. Social security number</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>3. Stock ownership</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Number of shares</td>
<td></td>
<td></td>
</tr>
<tr>
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<td>Date acquired</td>
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<td></td>
<td>Date of disposition</td>
<td></td>
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<tr>
<td></td>
<td>4. Compensation</td>
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<td>5. Percentage of time devoted to business</td>
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Instructions for Corporation

Copy A—Must be attached to Form 1120S.

Copy B—To be given to each shareholder.

Copy C—May be retained for your records.

Complete a separate Schedule K-1 (Form 1120S) for each person who was a shareholder during the taxable year. Additional instructions for completing Schedule K-1 are on page 5 of the Instructions for Form 1120S.

Schedule K-1 (Form 1120S) must show complete information for all persons who were shareholders of the corporation during any part of the taxable year.

Please give special attention to the completeness and legibility of the shareholder’s name and identifying number.

The corporation may be subject to a penalty for each omission of a shareholder’s identifying number unless the corporation establishes a reasonable cause for not providing it.

Under the tax treatment provided by Subchapter S, shareholders generally are taxed on their distributive shares of the current taxable income of the corporation, whether or not actually distributed. In addition to this undistributed taxable income, Schedule K-1 also includes each shareholder’s pro rata share of: any section 465 losses, items of tax preference, items used to compute the limitation on the deduction for investment interest expense, property eligible for investment credit, property used in recomputing a prior year investment credit, new jobs credit and other shareholder information. See instructions on Form 4255 for exceptions and limitations on the recapture of investment credit.

Report actual dividend distributions aggregating $10 or more to a shareholder during the calendar year on Form 1099-DIV.

If a prior actual distribution reported to shareholders as ordinary income on Form 1099-DIV is determined to be capital gain at the close of the corporation’s taxable year, the corporation must issue amended Forms 1099-DIV to the shareholders.
Election by a Small Business Corporation

(As to taxable status under subchapter S of the Internal Revenue Code)

NOTE.—This election under section 1372(a) (with the consent of all your stockholders) to be treated as an "electing small business corporation" for income tax purposes may be made only if the corporation meets all six of the requirements stated in instruction A.

Name of corporation

Employer Identification number (see instr. L)

Principal business activity (see instr. E)

Number and street

City or town, State and ZIP code

Is the corporation the outgrowth or continuation of any form of predecessor? □ Yes □ No. If "Yes," state name of predecessor, type of organization, and period during which it was in existence.

If this election is effective for the first taxable year the corporation is in existence, submit the following information:

Date corporation first had shareholders

Date corporation first had assets

Date corporation began doing business

Annual return will be filed for taxable year ending (Month)

Name and address (including ZIP code) of each shareholder

No. of shares

Date(s) acquired (see instr. D)

Social Security Number

Internal Revenue Service Center where individual return is filed

Stock

NOTE.—For this election to be valid, the consent of each stockholder must accompany this form or be shown below. See instruction D.

Under penalties of perjury, I declare that I have examined this election, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

Signature and Title of Officer __________________________ Date __________________________, 19...

Shareholders’ statement of consent (May be used in lieu of attachments—see instruction D)

We the undersigned shareholders consent to the election of the above corporation to be treated as an "electing small business corporation" under section 1372(a).

Signature of shareholders and date

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(Send both copies to the Internal Revenue Service.)
Purpose
(References are to the Internal Revenue Code.)
The purpose of this election is to permit the undistributed taxable income of an "electing small business corporation" to be taxed to the shareholders rather than the corporation. The term "undistributed taxable income" means taxable income (as computed under section 1372(d)) minus the sum of (1) the tax imposed by sections 56 and 1378(a) and (2) the amount of money distributed as dividends out of earnings and profits of the taxable year.

Instructions
A. Corporations eligible to elect. —The corporation may make the election only if it meets all six of the following requirements:
• It is a domestic corporation.
• It has no more than 10 shareholders.
• Stock is held as owned by one shareholder when held by a husband and wife as joint tenants, tenants by the entireties, or tenants in common, or is community property (or the income from which is community income).
• It has only individuals or estates as shareholders.
• It has no nonresident alien shareholders.
• It has only one class of stock.

Note.—Stock is treated as owned by one shareholder when held by a husband and wife as joint tenants, tenants by the entireties, or tenants in common, or is community property (or the income from which is community income).

B. When to make the election.—Complete this form and file it for any taxable year during either (1) the first month of that year, or (2) the month before the first month. For example, a calendar-year corporation must make the election either in January of the tax year it applies to or in the preceding December.

For this purpose, the first month of a new corporation's taxable year begins when it has shareholders, acquires assets, or begins doing business, whichever happens first.

If a new corporation's taxable year begins after the first day of a month, the term "month" is the period beginning with the first day of the taxable year and ending with the close of the day preceding the same date of the following calendar month.

For example, if the new corporation's tax year began on March 17, the election must be filed by April 16. But if it began on March 31, the election must be filed by April 30.

The election will be effective for the taxable year for which it is made and for all later years unless it is terminated or revoked under section 1372(e).

C. Valid election.—The election will be valid only if consented to by all persons who are shareholders on the first day of the corporation's taxable year or on the day of election, whichever is later.

D. Shareholder's statement of consent.—On the date of election, each shareholder must consent to the election either by signing at the bottom of Form 2553 or by signing a separate statement which must be attached to Form 2553 and must include:
• the name and address of the corporation and of the shareholder
• the number of shares of stock owned by the shareholder
• the dates the shares were acquired

E. Statement that the shareholder consents to the corporation's election to be treated as a small business corporation under section 1372(a).

F. Where to file.—File this election in duplicate with the Internal Revenue Service Center where the corporation will file Form 1120S, U.S. Small Business Corporation Income Tax Return.

G. Signature.—This form must be signed by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or any other person authorized (such as tax officer) who is authorized to sign.

H. Election after termination or revocation.—If a corporation has been terminated or revoked under section 1372(e), the corporation may, under section 1372(f), make an election to be an "electing small business corporation" and the tax recomputation provisions of section 47 will apply.

I. Annual return.—The corporation must file Form 1120S annually and attach a copy of each shareholder's consent which was filed subsequently to this Form 2553.

J. Investment credit property.—Section 47 and the regulations thereunder provide that investment credit property ceases to be investment credit property when a corporation makes the election under section 1372 for an "electing small business corporation" and the tax recomputation provisions of section 47 will apply.

K. Work incentive (WIN) program credit.—Section 1.50A-5(b)(1) of the regulations provides that certain WIN wages for which the WIN credit was claimed will cease to qualify this provision will apply when the corporation makes a valid election under section 1372 to be an "electing small business corporation." Therefore, the recapture provisions of section 1.50A-5(b)(2) of the regulations will apply.

The corporation and its shareholders may, however, execute the agreement specified in section 1.47-1(a) of the regulations so that the recapture provisions of section 1.47-1(a) of the regulations will not apply to the WIN credit.

L. Employer identification number.—Corporations that have not applied for an employer identification number should enter "not applied for." If a number has been applied for but not received, enter "applied for."
Application for Automatic Extension of Time to File Corporation Income Tax Return
(Under section 6081(b) of the Internal Revenue Code)

Note: Prepare this form in duplicate. File the original with the Internal Revenue Service Center where you are required to file your income tax return; also, attach a copy to your income tax return.

A penalty for failure to pay tax will generally be imposed upon any corporation which files Form 7004 and underestimates by more than 10% its tentative amount of income tax for the taxable year. See instruction G.

Name of corporation

Number and street

City or town, State, and ZIP code

1. An automatic 3-month extension of time until , 19 , is hereby requested in which to file the income tax return of the corporation named above for the taxable year beginning , 19 , and ending , 19 .

2. Does this application also cover subsidiaries to be included in a consolidated return? □ Yes □ No
   If “Yes,” complete the following:

   Name and Address of Each Member of the Affiliated Group

   Employer Identification No.

3. 50% of the tax tentatively determined to be due (line 3(c)) must be deposited on or before the original due date of the corporation’s income tax return. See instructions for depositary method of payment.

   A penalty for failure to pay tax will generally be imposed upon any corporation which files Form 7004 and underestimates by more than 10% its tentative amount of income tax for the taxable year. See instruction G.

   (a) Tentative amount of income tax for the taxable year including any—
      Minimum tax on tax preference items
      Personal holding company tax
      Tax from recomputing a prior year investment credit
      Tax from recomputing a prior year work incentive (WIN) credit
      Foreign tax credit
      Possession tax credit
      Investment credit
      WIN credit
      New jobs credit

   (b) Less: (i) Overpayment from prior year allowed as a credit
      (ii) Estimated tax payments (deposits) for the taxable year
      (iii) Less refund of estimated tax for the taxable year applied for on Form 4466
      (iv) Credit from regulated investment companies
      (v) Credit for U.S. tax on special fuels, nonhighway gas and lubricating oil

   (c) Balance due

   (d) Amount required to be deposited—50% of line 3(c)

Signature (See instruction J).—Under penalties of perjury, I declare that I have been authorized by the above-named corporation to make this application, and that to the best of my knowledge and belief the statements made herein are true, correct, and complete.

A Copy of This Application Must Be Attached to the Corporation’s Income Tax Return

Form 7004 (Rev. 11-77)
Instructions

(References are to the Internal Revenue Code.)

A. Depositary Method of Payment.—Foreign corporations having an office or place of business within the United States and domestic corporations must deposit all income tax payments at an authorized commercial bank depositary or Federal Reserve Bank or Branch (FRB), with a Federal Tax Deposit Form preinscribed with a Tax Class Number 503, in accordance with instructions appearing on the reverse of that form. Deposits made at a FRB must be made with the FRB servicing the geographic area where a taxpayer is located. The deposit must be made in a form of credit item. Additional information can be obtained from a Federal Tax Deposit Form preinscribed with a Tax Class Number 503. Do not remit directly to Internal Revenue. Records of deposits will be sent to Internal Revenue for crediting to the corporation's account.

The timeliness of deposits will be determined by date received by a commercial bank depositary or FRB. If a tax payment is made by mail, a deposit received after the due date will be considered timely if the taxpayer establishes that it was mailed on or before the second day before the prescribed due date as provided by section 7502. Tax deposits made at FRBs which are not in compliance with deposit requirements will nevertheless be processed by the receiving FRB rather than returned to the taxpayer. Furthermore, such tax payments received by an FRB will be dated as paid based upon the date when the proceeds of the accompanying payment instrument are collected by the FRB, and if made by mail section 7502 will not apply.

Federal Tax Deposit Forms preinscribed with a Tax Class Number 503 will be mailed to domestic corporations on a cyclical basis depending on the taxable year of the corporation. Domestic and foreign corporations needing such forms may obtain them from the Internal Revenue Service Center where they will file their returns. The application should include the corporation's name, identification number, address, and the taxable year to which the deposits relate, and a statement identifying the corporation as being foreign or domestic.

B. Who May File.—This application is to be used by a corporation to request an automatic 3-month extension of time to file its income tax return. The extension is allowed upon the timely and proper filing of this form and timely deposit of the required amount in accordance with instructions A and E.

If the corporation needs a further extension beyond the 3 months automatically allowed by the filing of Form 7004, an application may be filed on Form 7005, Application for Additional Extension of Time to File Corporation Income Tax Return.

Note: A Domestic International Sales Corporation (DISC) is not allowed an extension of time to file its return.

C. When to File.—File this application on or before the original due date of the corporation's income tax return.

D. How and Where to File.—File this form with the Internal Revenue Service Center where the corporation will file its income tax return. Also, attach a copy of this form to the corporation's income tax return when it is filed. The corporation's income tax return may be filed any time prior to the expiration of the 3-month period.

If the corporation's principal business, office or agency is located in

Illinois, Iowa, Missouri, Wisconsin
California, Hawaii
Indiana, Kentucky, North Carolina, Tennessee, Virginia, West Virginia
Delaware, District of Columbia, Maryland, Pennsylvania
U.S. corporations having their principal place of business outside the U.S., corporations claiming a credit under section 936, foreign corporations filing Form 1120F, organizations filing Form 990-C or 990-T, and section 501(c) organizations filing Form 1120-POL should file Form 7004 with the Internal Revenue Service Center, Philadelphia, PA 19255.

If the separate income tax returns of a group of corporations located in several Service Center regions will be filed with the Service Center for the area in which the principal office of the managing corporation that keeps all the books and records is located, then such corporations should file Form 7004 with that Service Center.

E. Amount of Deposit.—The corporation must deposit the amount that would be required if it elected to pay its final tax liability in two installments. The installment privilege is limited to the amount shown on line 3(c) of this form.

F. Interest.—Any portion of the final tax not shown on line 3(c) will bear interest at a rate pursuant to section 6621 from the original due date of the corporate return to the date of payment.

G. Penalty for Failure to Pay Tax.—Section 6651 imposes a penalty for failure to pay tax (other than estimated income tax) when due.

The late payment penalty is 1 1/2% a month or fractional part of a month unless there is reasonable cause for failure to pay on time. If you have reasonable cause, attach a statement to your income tax return giving your reason(s).

Reasonable cause shall be presumed, however, for the period of the extension of time to file, with respect to any underpayment of tax if all three of the following conditions are met:

(1) 50% of the tax shown on line 3(c) of Form 7004 is to be paid on or before the regular due date of the return and the remaining 50% is to be paid on or before 3 months after such date,

(2) the tax shown on line 3(a) of Form 7004 (or the amount of tax paid on or before the regular due date of the return) is at least 93% of the tax shown on line 31 (Line 31 is total tax before taking into account refundable credits and prepayments of tax. Those filing Forms 1120F, 1120L, 1120M, 1120S, 990-C, 990-T, 1120-H or 1120-POL will use the tax on the line comparable to line 31.) AND

(3) any balance due shown on the return is paid on or before the due date of the return including any extensions of time for filing.

H. Consolidated Returns.—If a consolidated return is to be filed, a parent corporation may request extensions for its subsidiaries. In such case, the name, address, and employer identification number of each member of the affiliated group for which the extension is desired must be listed in item 2.

The filing of this form by a parent corporation is not considered as an exercise of the privilege of making a consolidated return.

I. Termination of Extension.—Internal Revenue may terminate the automatic extension at any time by mailing a notice of termination to the corporation or to the person who requested the extension for the corporation. The notice will be mailed at least 10 days prior to the termination date designated in the notice.

J. Signature.—Form 7004 must be signed by a person authorized by the corporation to do so, and who is either (a) an officer of the corporation, (b) a duly authorized agent holding a power of attorney, (c) a person currently enrolled to practice before the Internal Revenue Service, or (d) an attorney or certified public accountant qualified to practice before the Internal Revenue Service under Public Law 89-332.

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(4) the capital loss carryover under section 1212(a), and

(5) such other items as may be specified by such regulations,

for the taxable year of a recovery of a foreign expropriation loss to which this section applies, and for succeeding taxable years, to take into account items changed in making the computations under subsection (d) for taxable years prior to the taxable year of such recovery.


Editorial Notes


Pub.L. 89-389, § 4(a) (4), struck out subsec. (m) which provided that, with stated exceptions, an enterprise as to which an election had been made under subsection (a) could not be considered a corporation, nor its proprietors or partners considered shareholders, for purposes of revenue provisions relating to corporate organizations and reorganizations and insolvency reorganizations.

SUBCHAPTER S—ELECTION OF CERTAIN SMALL BUSINESS CORPORATIONS AS TO TAXABLE STATUS

Sec.
1371. Definitions.
1372. Election by small business corporation.
1373. Corporation undistributed taxable income taxed to shareholders.
1374. Corporation net operating loss allowed to shareholders.
1375. Special rules applicable to distributions of electing small business corporations.
1376. Adjustment to basis of stock of, and indebtedness owing, shareholders.
1377. Special rules applicable to earnings and profits of electing small business corporations.
1378. Tax imposed on certain capital gains.
1379. Certain qualified pensions, etc., plans.

§ 1371. Definitions

(a) Small business corporation.—For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not a member of an affiliated group (as defined in section 1504) and which does not—

(1) have (except as provided in subsection (e)) more than 10 shareholders;

(2) have as a shareholder a person (other than an estate and other than a trust described in subsection (f)) who is not an individual;
(3) have a nonresident alien as a shareholder; and
(4) have more than one class of stock.

(b) Electing small business corporation.—For purposes of this subchapter, the term “electing small business corporation” means, with respect to any taxable year, a small business corporation which has made an election under section 1372(a) which, under section 1372, is in effect for such taxable year.

(c) Stock owned by husband and wife.—For purposes of subsection (a)(1) stock which—

(1) is community property of a husband and wife (or the income from which is community income) under the applicable community property law of a State,
(2) is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common,
(3) was, on the date of death of a spouse, stock described in paragraph (1) or (2), and is, by reason of such death, held by the estate of the deceased spouse and the surviving spouse, or by the estates of both spouses (by reason of their deaths on the same date), in the same proportion as held by the spouses before such death, or
(4) was, on the date of the death of a surviving spouse, stock described in paragraph (3), and is, by reason of such death, held by the estates of both spouses in the same proportion as held by the spouses before their deaths,

shall be treated as owned by one shareholder.

(d) Ownership of certain stock.—For purposes of subsection (a), a corporation shall not be considered a member of an affiliated group at any time during any taxable year by reason of the ownership of stock in another corporation if such other corporation—

(1) has not begun business at any time on or after the date of its incorporation and before the close of such taxable year, and

(2) does not have taxable income for the period included within such taxable year.

(e) Special shareholder rules.—

(1) A small business corporation which has been an electing small business corporation for a period of five consecutive taxable years may not have more than 15 shareholders.

(2) If, during the 5-year period set forth in paragraph (1), the number of shareholders of an electing small business corporation increases to an amount in excess of 10 (but not in excess of 15) solely by reason of additional shareholders who acquired their stock through inheritance, the corporation may have a number of additional shareholders equal to the number by which the inheriting shareholders cause the total number of shareholders of such corporation to exceed 10.

(f) Certain trusts permitted as shareholders.—For purposes of subsection (a), the following trusts may be shareholders:

(1) A trust all of which is treated as owned by the grantor under subpart E of part I of subchapter J of this chapter.

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(2) A trust created primarily to exercise the voting power of stock transferred to it.

(3) Any trust with respect to stock transferred to it pursuant to the terms of a will, but only for the 60-day period beginning on the day on which such stock is transferred to it.

In the case of a trust described in paragraph (2), each beneficiary of the trust shall, for purposes of subsection (a) (1), be treated as a shareholder.


§ 1372. Election by small business corporation

(a) Eligibility.—Except as provided in subsection (f), any small business corporation may elect, in accordance with the provisions of this section, not to be subject to the taxes imposed by this chapter. Such election shall be valid only if all persons who are shareholders in such corporation—

(1) on the first day of the first taxable year for which such election is effective, if such election is made on or before such first day, or

(2) or the day on which the election is made, if the election is made after such first day,

consent to such election.

(b) Effect.—If a small business corporation makes an election under subsection (a), then—

(1) with respect to the taxable years of the corporation for which such election is in effect, such corporation shall not be subject to the taxes imposed by this chapter (other than as provided by section 58(d) (2) and by section 1378) and, with respect to such taxable years and all succeeding taxable years, the provisions of section 1377 shall apply to such corporation, and

(2) with respect to the taxable years of a shareholder of such corporation in which or with which the taxable years of the corporation for which such election is in effect end, the provisions of sections 1373, 1374, and 1375 shall apply to such shareholder, and with respect to such taxable years and all succeeding taxable years, the provisions of section 1376 shall apply to such shareholder.

(c) Where and how made.—An election under subsection (a) may be made by a small business corporation for any taxable year at any time during the first month of such taxable year, or at any time during the month preceding such first month. Such election shall be made in such manner as the Secretary shall prescribe by regulations.

(d) Years for which effective.—An election under subsection (a) shall be effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, unless it is terminated, with respect to any such taxable year, under subsection (e).

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(c) Termination.—

(1) New shareholders.—

(A) An election under subsection (a) made by a small business corporation shall terminate if any person who was not a shareholder in such corporation—

(i) on the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day, or

(ii) on the day on which the election is made, if such election is made after such first day,

becomes a shareholder in such corporation and affirmatively refuses (in such manner as the Secretary shall by regulations prescribe) to consent to such election on or before the 60th day after the day on which he acquires the stock.

(B) If the person acquiring the stock is the estate of a decedent, the period under subparagraph (A) for affirmatively refusing to consent to the election shall expire on the 60th day after whichever of the following is the earlier:

(i) The day on which the executor or administrator of the estate qualifies; or

(ii) The last day of the taxable year of the corporation in which the decedent died.

(C) Any termination of an election under subparagraph (A) by reason of the affirmative refusal of any person to consent to such election shall be effective for the taxable year of the corporation in which such person becomes a shareholder in the corporation and for all succeeding taxable years of the corporation.

(2) Revocation.—An election under subsection (a) made by a small business corporation may be revoked by it for any taxable year of the corporation after the first taxable year for which the election is effective. An election may be revoked only if all persons who are shareholders in the corporation on the day on which the revocation is made consent to the revocation. A revocation under this paragraph shall be effective—

(A) for the taxable year in which made, if made before the close of the first month of such taxable year,

(B) for the taxable year following the taxable year in which made, if made after the close of such first month,

and for all succeeding taxable years of the corporation. Such revocation shall be made in such manner as the Secretary shall prescribe by regulations.

(3) Ceases to be small business corporation.—An election under subsection (a) made by a small business corporation shall terminate if at any time—

(A) after the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day, or

(B) after the day on which the election is made, if such election is made after such first day,
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the corporation ceases to be a small business corporation (as defined in section 1371(a)). Such termination shall be effective for the taxable year of the corporation in which the corporation ceases to be a small business corporation and for all succeeding taxable years of the corporation.

(4) Foreign income.—An election under subsection (a) made by a small business corporation shall terminate if for any taxable year of the corporation for which the election is in effect, such corporation derives more than 80 percent of its gross receipts from sources outside the United States. Such termination shall be effective for the taxable year of the corporation in which it derives more than 80 percent of its gross receipts from sources outside the United States, and for all succeeding taxable years of the corporation.

(5) Passive investment income.—

(A) Except as provided in subparagraph (B), an election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent of which is passive investment income. Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.

(B) Subparagraph (A) shall not apply with respect to a taxable year in which a small business corporation has gross receipts more than 20 percent of which is passive investment income, if—

(i) such taxable year is the first taxable year in which the corporation commenced the active conduct of any trade or business or the next succeeding taxable year; and

(ii) the amount of passive investment income for such taxable year is less than $3,000.

(C) For purposes of this paragraph, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). Gross receipts derived from sales or exchanges of stock or securities for purposes of this paragraph shall not include amounts received by an electing small business corporation which are treated under section 331 (relating to corporate liquidations) as payments in exchange for stock where the electing small business corporation owned more than 50 percent of each class of the stock of the liquidating corporation.

(f) Election after termination.—If a small business corporation has made an election under subsection (a) and if such election has been terminated or revoked under subsection (e), such corporation (and any successor corporation) shall not be eligible to make an election under subsection (a) for any taxable year prior to its fifth taxable year which begins after the first taxable year for which such termination or revocation is effective, unless the Secretary consents to such election.

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§ 1373. Corporation undistributed taxable income taxed to shareholders

(a) General rule.—The undistributed taxable income of an electing small business corporation for any taxable year shall be included in the gross income of the shareholders of such corporation in the manner and to the extent set forth in this section.

(b) Amount included in gross income.—Each person who is a shareholder of an electing small business corporation on the last day of a taxable year of such corporation shall include in his gross income, for his taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend, if on such last day there had been distributed pro rata to its shareholders by such corporation an amount equal to the corporation's undistributed taxable income for the corporation's taxable year. For purposes of this chapter, the amount so included shall be treated as an amount distributed as a dividend on the last day of the taxable year of the corporation.

(c) Undistributed taxable income defined.—For purposes of this section, the term "undistributed taxable income" means taxable income (computed as provided in subsection (d)) minus the sum of (1) the taxes imposed by sections 56 and 1378(a) and (2) the amount of money distributed as dividends during the taxable year, to the extent that any such amount is a distribution out of earnings and profits of the taxable year as specified in section 316(a)(2).

(d) Taxable income.—For purposes of this subchapter, the taxable income of an electing small business corporation shall be determined without regard to—

1. the deduction allowed by section 172 (relating to net operating loss deduction), and
2. the deductions allowed by part VIII of subchapter B (other than the deduction allowed by section 248, relating to organization expenditures).

§ 1374. Corporation net operating loss allowed to shareholders

(a) General rule.—A net operating loss of an electing small business corporation for any taxable year shall be allowed as a deduction from gross income.
§ 1374  INCOME TAXES  Ch. 1

income of the shareholders of such corporation in the manner and to the extent set forth in this section.

(b) Allowance of deduction.—Each person who is a shareholder of an electing small business corporation at any time during a taxable year of the corporation in which it has a net operating loss shall be allowed as a deduction from gross income, for his taxable year in which or with which the taxable year of the corporation ends (or for the final taxable year of a shareholder who dies before the end of the corporation's taxable year), an amount equal to his portion of the corporation's net operating loss (as determined under subsection (c)). The deduction allowed by this subsection shall, for purposes of this chapter, be considered as a deduction attributable to a trade or business carried on by the shareholder.

(c) Determination of shareholder's portion.—

(1) In general.—For purposes of this section, a shareholder's portion of the net operating loss of an electing small business corporation is his pro rata share of the corporation's net operating loss (computed as provided in section 172(c), except that the deductions provided in part VIII (except section 248) of subchapter B shall not be allowed) for his taxable year in which or with which the taxable year of the corporation ends. For purposes of this paragraph, a shareholder's pro rata share of the corporation's net operating loss is the sum of the portions of the corporation's daily net operating loss attributable on a pro rata basis to the shares held by him on each day of the taxable year. For purposes of the preceding sentence, the corporation's daily net operating loss is the corporation's net operating loss divided by the number of days in the taxable year.

(2) Limitation.—A shareholder's portion of the net operating loss of an electing small business corporation for any taxable year shall not exceed the sum of—

(A) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of the shareholder's stock in the electing small business corporation, determined as of the close of the taxable year of the corporation (or, in respect of stock sold or otherwise disposed of during such taxable year, as of the day before the day of such sale or other disposition), and

(B) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of any indebtedness of the corporation to the shareholder, determined as of the close of the taxable year of the corporation (or, if the shareholder is not a shareholder as of the close of such taxable year, as of the close of the last day in such taxable year on which the shareholder was a shareholder in the corporation).


Editorial Notes

Subsection (d), relating to application with other provisions, was repealed by Pub.L. 94–455, Title XIX, § 1902(a) (150), Oct. 4, 1976, 90 Stat. 1784, applicable to taxable years beginning after Dec. 31, 1976.

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§ 1375. Special rules applicable to distributions of electing small business corporations

(a) Capital gains.—

(1) Treatment in hands of shareholders.—The amount includible in the gross income of a shareholder as dividends (including amounts treated as dividends under section 1373(b)) from an electing small business corporation during any taxable year of the corporation, to the extent that such amount is a distribution of property out of earnings and profits of the taxable year as specified in section 316(a) (2), shall be treated as a long-term capital gain to the extent of the shareholder's pro rata share of the corporation's net capital gain for such taxable year. For purposes of this paragraph, such net capital gain shall be deemed not to exceed the corporation's taxable income (computed as provided in section 1373(d)) for the taxable year.

(2) Determination of shareholder's pro rata share.—A shareholder's pro rata share of such excess for any taxable year shall be an amount which bears the same ratio to such excess as the amount of dividends described in paragraph (1) includible in the shareholder's gross income bears to the entire amount of dividends described in paragraph (1) includible in the gross income of all shareholders.

(3) Reduction for taxes imposed.—For purposes of paragraphs (1) and (2), an electing small business corporation's net capital gain for a taxable year shall be reduced by an amount equal to the amount of the taxes imposed by sections 56 and 1378(a) on such corporation for such year.

(b) Dividends not treated as such for certain purposes.—The amount includible in the gross income of a shareholder as dividends from an electing small business corporation during any taxable year of the corporation (including any amount treated as a dividend under section 1373(b)) shall not be considered a dividend for purposes of section 37 or section 116 to the extent that such amount is a distribution of property out of earnings and profits of the taxable year as specified in section 316(a) (2). For purposes of this subsection, the earnings and profits of the taxable year shall be deemed not to exceed the corporation's taxable income (computed as provided in section 1373(d)) for the taxable year.

(c) Treatment of family groups.—Any dividend received by a shareholder from an electing small business corporation (including any amount treated as a dividend under section 1373(b)) may be apportioned or allocated by the Secretary between or among shareholders of such corporation who are members of such shareholder's family (as defined in section 701(e) (3)), if he determines that such apportionment or allocation is necessary in order to reflect the value of services rendered to the corporation by such shareholders.

(d) Distributions of undistributed taxable income previously taxed to shareholders.—

(1) Distributions not considered as dividends.—An electing small business corporation may distribute, in accordance with regulations prescribed by the Secretary, to any shareholder all or any portion of the shareholder's net share of the corporation's undistributed taxable in-
come for taxable years prior to the taxable year in which such distribution is made. Any such distribution shall, for purposes of this chapter, be considered a distribution which is not a dividend, but the earnings and profits of the corporation shall not be reduced by reason of any such distribution.

(2) Shareholder's net share of undistributed taxable income.—For purposes of this subsection, a shareholder's net share of the undistributed taxable income of an electing small business corporation is an amount equal to—

(A) the sum of the amounts included in the gross income of the shareholder under section 1373(b) for all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year), reduced by

(B) the sum of—

(i) the amounts allowable under section 1374(b) as a deduction from gross income of the shareholder for all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year), and

(ii) all amounts previously distributed during the taxable year and all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year) to the shareholder which under subsection (f) or paragraph (1) of this subsection were considered distributions which were not dividends.


(f) Distributions within 24-month period after close of taxable year.—

(1) Distributions considered as distributions of undistributed taxable income.—Any distribution of money made by a corporation after the close of a taxable year with respect to which it was an electing small business corporation and on or before the 15th day of the third month following the close of such taxable year to a person who was a shareholder of such corporation at the close of such taxable year shall be treated as a distribution of the corporation's undistributed taxable income for such year, to the extent such distribution (when added to the sum of all prior distributions of money made to such person by such corporation following the close of such year) does not exceed such person's share of the corporation's undistributed taxable income for such year. Any distribution so treated shall, for purposes of this chapter, be considered a distribution which is not a dividend, and the earnings and profits of the corporation shall not be reduced by reason of such distribution.

(2) Share of undistributed taxable income.—For purposes of paragraph (1), a person's share of a corporation's undistributed taxable income for a taxable year is the amount required to be included in his gross income under section 1373(b) as a shareholder of such corporation for his taxable year in which or with which the taxable year of the corporation ends.

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§ 1376. Adjustment to basis of stock of, and indebtedness owing, shareholders

(a) Increase in basis of stock for amounts treated as dividends.—The basis of a shareholder's stock in an electing small business corporation shall be increased by the amount required to be included in the gross income of such shareholder under section 1373(b), but only to the extent to which such amount is included in his gross income in his return, increased or decreased by any adjustment of such amount in any redetermination of the shareholder's tax liability.

(b) Reduction in basis of stock and indebtedness for shareholder's portion of corporation net operating loss.—

(1) Reduction in basis of stock.—The basis of a shareholder's stock in an electing small business corporation shall be reduced (but not below zero) by an amount equal to the amount of his portion of the corporation's net operating loss for any taxable year attributable to such stock (as determined under section 1374(c)).

(2) Reduction in basis of indebtedness.—The basis of any indebtedness of an electing small business corporation to a shareholder of such corporation shall be reduced (but not below zero) by an amount equal to the amount of the shareholder's portion of the corporation's net operating loss for any taxable year (as determined under section 1374(c)), but only to the extent that such amount exceeds the adjusted basis of the stock of such corporation held by the shareholder.

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(b) Current earnings and profits not reduced by any amount not allowable as deduction.—The earnings and profits of an electing small business corporation for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income (as provided in section 1373(d)) for such taxable year.

(c) Earnings and profits not affected by net operating loss.—The earnings and profits and the accumulated earnings and profits of an electing small business corporation shall not be affected by any item of gross income or any deduction taken into account in determining the amount of any net operating loss (computed as provided in section 1374(c)) of such corporation.

(d) Distributions of undistributed taxable income previously taxed to shareholders.—For purposes of determining whether a distribution by an electing small business corporation constitutes a distribution of such corporation's undistributed taxable income previously taxed to shareholders (as provided for in section 1375(d)), the earnings and profits of such corporation for the taxable year in which the distribution is made shall be computed without regard to section 312(k). Such computation shall be made without regard to section 312(k) only for such purposes.


§ 1378. Tax imposed on certain capital gains

(a) General rule.—If for a taxable year of an electing small business corporation—

(1) the net capital gain of such corporation exceeds $25,000, and

(2) the taxable income of such corporation for such year exceeds $25,000,

there is hereby imposed a tax (computed under subsection (b)) on the income of such corporation.

(b) Amount of tax.—The tax imposed by subsection (a) shall be the lower of—

(1) an amount equal to the tax, determined as provided in section 1201(a), on the amount by which the net capital gain of the corporation for the taxable year exceeds $25,000, or

(2) an amount equal to the tax which would be imposed by section 11 on the taxable income (computed as provided in section 1373(d)) of the corporation for the taxable year if the corporation was not an electing small business corporation.

No credit shall be allowable under part IV of subchapter A of this chapter (other than under section 39) against the tax imposed by subsection (a).

(c) Exceptions.—

(1) In general.—Subsection (a) shall not apply to an electing small business corporation for any taxable year if the election under section 1012
1372(a) which is in effect with respect to such corporation for each taxable year has been in effect for the 3 immediately preceding taxable years.

(2) New corporations.—Subsection (a) shall not apply to an electing small business corporation if—

(A) it has been in existence for less than 4 taxable years, and

(B) an election under section 1372(a) has been in effect with respect to such corporation for each of its taxable years.

(3) Property with substituted basis.—If—

(A) but for paragraph (1) or (2), subsection (a) would apply for the taxable year,

(B) any long-term capital gain is attributable to property acquired by the electing small business corporation during the period beginning 3 years before the first day of the taxable year and ending on the last day of the taxable year, and

(C) the basis of such property is determined in whole or in part by reference to the basis of any property in the hands of another corporation which was not an electing small business corporation throughout all of the period described in subparagraph (B) before the transfer by such other corporation and during which such other corporation was in existence,

then subsection (a) shall apply for the taxable year, but the amount of the tax determined under subsection (b) shall not exceed a tax, determined as provided in section 1201(a), on the net capital gain attributable to property acquired as provided in subparagraph (B) and having a basis described in subparagraph (C).


§ 1379. Certain qualified pension, etc., plans

(a) Additional requirement for qualification of stock bonus or profit-sharing plans.—A trust forming part of a stock bonus or profit-sharing plan which provides contributions or benefits for employees some or all of whom are shareholder-employees shall not constitute a qualified trust under section 401 (relating to qualified pension, profit-sharing, and stock bonus plans) unless the plan of which such trust is a part provides that forfeitures attributable to contributions deductible under section 404(a) (3) for any taxable year (beginning after December 31, 1970) of the employer with respect to which it is an electing small business corporation may not inure to the benefit of any individual who is a shareholder-employee for such taxable year. A plan shall be considered as satisfying the requirement of this subsection for the period beginning with the first day of a taxable year and ending with the 15th day of the third month following the close of such taxable year, if all the provisions of the plan which are necessary to satisfy this requirement are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period.

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(b) Taxability of shareholder-employee beneficiaries.—

(1) Inclusion of excess contributions in gross income.—Notwithstanding the provisions of section 402 (relating to taxability of beneficiary of employees' trust), section 403 (relating to taxation of employee annuities), or section 405(d) (relating to taxability of beneficiaries under qualified bond purchase plans), an individual who is a shareholder-employee of an electing small business corporation shall include in gross income, for his taxable year in which or with which the taxable year or the corporation ends, the excess of the amount of contributions paid on his behalf which is deductible under section 404(a) (1), (2), or (3) by the corporation for its taxable year over the lesser of—

(A) 15 percent of the compensation received or accrued by him from such corporation during its taxable year, or

(B) $7,500.

(2) Treatment of amounts included in gross income.—Any amount included in the gross income of a shareholder-employee under paragraph (1) shall be treated as consideration for the contract contributed by the shareholder-employee for purposes of section 72 (relating to annuities).

(3) Deduction for amounts not received as benefits.—If—

(A) amounts are included in the gross income of an individual under paragraph (1), and

(B) the rights of such individual (or his beneficiaries) under the plan terminate before payments under the plan which are excluded from gross income equal the amounts included in gross income under paragraph (1),

then there shall be allowed as a deduction, for the taxable year in which such rights terminate, an amount equal to the excess of the amounts included in gross income under paragraph (1) over such payments.

c) Carryover of amounts deductible.—No amount deductible shall be carried forward under the second sentence of section 404(a) (3) (A) (relating to limits on deductible contributions under stock bonus and profit-sharing trusts) to a taxable year of a corporation with respect to which it is not an electing small business corporation from a taxable year (beginning after December 31, 1970) with respect to which it is an electing small business corporation.

d) Shareholder-employee.—For purposes of this section, the term "shareholder-employee" means an employee or officer of an electing small business corporation who owns (or is considered as owning within the meaning of section 318(a) (1), on any day during the taxable year of such corporation, more than 5 percent of the outstanding stock of the corporation.