

## **Module 3.8: S Corporation Taxation**

We will discuss S corporations last because they are a hybrid entity. Electing subchapter S status allows shareholders the benefits of limited liability that a C corporation affords. Unlike a partnership, individual shareholders are not liable for the debts of the corporation, nor can they be sued in their personal capacity for the corporation's or its employees actions.

Like a partnership, S corporation income is taxed at the shareholder level rather than the entity level, and therefore, at individual, rather than corporate rates. Further, electing S corporation status allows the corporation to avoid the "double taxation" imposed on C corporations, where income is taxed once at the corporate level and then again after it is distributed to the shareholder as dividends.

### **What Information is Needed to Complete the Tax Return**

#### **Formation Documents**

To complete Form 1120-S, you will need the information regarding the formation of the corporation. You can generally find this information in the articles of incorporation filed with the state, the Form 2553 sent to the IRS and the letter the IRS sends to confirm the S election. This information includes:

- Name, address, and phone number of the corporation
- Employer identification number (EIN)
- Date of formation with the state
- Date of the S corporation election
- Name, address, social security or EIN, and percentage of ownership of each shareholder
- Basis of each shareholder
- Tax matters shareholder

#### **Business Assets Records**

As we discussed in the module on depreciation, if business assets have been purchased, you will need the purchase, description, and basis of each asset or group of assets for major improvements. Don't worry if the business depreciates these assets differently in the books than what is required for tax purposes. You will account for this if required to file Schedule M-1.

#### **Inventory**

If the corporation maintains an inventory, you will need the beginning and ending inventory numbers along with purchases (less any amounts removed for personal use). This information will be used in the cost of goods section of the return.

## **Financial Statements**

As we discussed in the Module 3.7 on C corporations, you will need the Income Statement (or Profit & Loss Statement) and the Balance Sheet. While the balance sheet does not have to be filed with the tax return if your S corporation had less than \$250,00 of gross receipts for the year, it is still good practice to include the information for proper accounting purposes.

## **The Impact of Making an S Corporation Election**

By electing to be an S corporation, like partnerships, the items of income, deductions, and credits flow to the shareholder through Schedule K-1 (1020-S) and are taxed on the shareholder's personal return as investment income instead of self-employment income which has created some additional considerations. We will go over the most important ones here:

### **Reasonable Compensation**

Unlike a sole proprietor, whose personal and business income is recognized as belonging to the same owner, an S corporation is a separate entity from its owner(s).

A sole proprietor cannot pay themselves a wage, since all the income and expenses flow to them as the owner of the sole proprietorship. Comparatively, an S corporation shareholder is not one and the same as the S corporation. They are two separate tax entities: the individual and the S corporation. When a shareholder works for the S corporation, they must be paid wages and issued a Form W-2, just like any other employee.

S corporations may have shareholders who only own stock in the corporation, or shareholders who are also employees of the S corporation. Those that are both shareholders and employees are often referred to as "shareholder-employees." The S corporation has to pay shareholder-employees reasonable compensation for their services.

A lot of newer S corporation owners do not realize this requirement, which can get them into big trouble with the IRS. This is because, by default, profits created by an S corporation are taxed as ordinary income and not subject to payroll taxes (social security & medicare), nor self-employment tax like partners in a partnership.

I've had the owners of so many S corporations sit down with me over the last two decades that were making \$80,000 to \$100,000 in profits and were not paying themselves a salary. The problem is that the IRS considers this evasion of payroll taxes. If they make this determination, the IRS can reclassify any part of the ordinary business income as reasonable compensation,

which will then be subject to payroll taxes as well as penalties and interest for not filing the payroll tax forms or paying the tax in a timely manner.

So what is reasonable compensation? The IRS has volumes of data showing what the average pay is for different types of jobs, which they don't really share so there is not definite answer to that. However, the guidance that is given is this: it should be what you would pay someone else to do the same job. For example, if you own a plumbing company and do most of the plumbing work now, what would you have to pay to replace yourself with another plumber.

One of the reasons S corporations because so popular is because it is the only legal format where you can shield part of your income from self-employment tax. If your company made \$100,000 profit for the year and it paid you a \$40,000 salary, then only the \$40,000 would be subject to the 15.3% self-employment taxes. Unlike sole proprietorships or partnerships, you would not have to pay it on other \$60,000 which would save you close to \$9,200 in taxes!

You may recall our earlier discussion of the Qualified Business Income deduction. Well, the amount included in reasonable compensation for shareholder-employees may affect an S corporation's qualified business income (QBI) deduction. Since the compensation does not qualify as QBI, higher amounts of "reasonable compensation" can lead to a reduction of qualified business income (QBI) deduction while "reasonable compensation" deemed too low by the IRS could result in reclassification by the IRS. The penalties for having a too low "reasonable compensation" is a lot more than any QBI saving, so I wouldn't advise playing that game.

### **S Corporation Medical Insurance**

If an S corporation pays health insurance premiums for a shareholder who is also an employee and that shareholder owns *more than a 2%* interest in the corporation, any health insurance or accident insurance premiums paid for that employee (or the employee's spouse or dependents) by the corporation must be included in wages.

The corporation deducts these amounts as wages paid and will include them in taxable income in box 1 of the employee's Form W-2. However, health insurance premiums treated as wages are not subject to social security, medicare, or unemployment taxes. Therefore, boxes 3 and 5 of the shareholder-employee's Form W-2 will not include these amounts.

The employee will have to include these amounts in their wages reported on line 1 of their Form 1040 and have taxes withheld from them. However, they may be eligible for a self-employed health insurance deduction on Schedule 1 (Form 1040) of their personal return. The health insurance may be in the name of the corporation or of the individual shareholder as long as all other requirements for the self-employed health insurance deduction are met. Health insurance

paid by the corporation for shareholders who are not employees does not qualify for the self-employed health insurance deduction.

But this may not be your best course of action. Recall that one of the qualifications for the self-employed health insurance deduction is that the taxpayer must not be eligible for employer-subsidized health insurance. Therefore, a 2% shareholder who is eligible to participate in a spouse's employer plan will not be able to take the deduction. In this case, tax would be paid on the premiums, but no deductions could be taken to get your tax money back.

### **Shareholder's Stock Basis**

Let's discuss how shareholder's in an S corporation must adjust the basis in their stock when they receive distributions of income, loss, and deductions on Schedule K-1. This adjusted basis is used to calculate:

- Your gain or loss when selling your shares
- How much of your pass-through losses are deductible on your personal return

As we discussed in Module 3.4 about basis, your initial stock basis in the corporation is the amount of your initial capital or property contribution you made to acquire your shares. This basis is then increased or decreased by the amounts on your Schedule K-1.

Remember that the stock basis cannot go below zero. As we discussed, you can bring it back to zero by adding capital to the corporation, becoming responsible for corporation debt, or you can just pay tax on the amount below zero.

### **Shareholder's Debt Basis**

One of the common occurrences in a small S corporation is to have the shareholders loan money to the corporation. These loans must be the same structure as borrowing from a bank and the corporation has to pay the shareholder interest of at least the minimum amount set by the IRS for the quarter the loan is made. This is referred to as the Applicable Federal Rate (AFR).

The applicable federal rate (AFR) is the minimum interest rate that the Internal Revenue Service (IRS) allows for private loans. Each month the IRS publishes a set of interest rates that the agency considers the minimum market rate for loans. The length of the loan should correspond to the AFRs: short-term (three years or less), mid-term (up to nine years), and long-term (more than nine years).

If the lender charges interest at a lower rate than the proper AFR, the IRS may reassess the loan and add interest to the shareholders income to reflect the AFR rather than the actual amount paid by the S corporation.

Shareholders who have loaned money to the corporation in their personal capacities will have a separate debt basis to keep track of. A shareholder's debt basis is the amount of loans that the corporation owes the shareholder with certain adjustments.

Like stock basis, it is the shareholder's responsibility to track their debt basis. Generally, a shareholder's debt basis may be reduced by the following adjustments:

- Property distributions not reported on Form 1099-DIV.
- Nondeductible expenses, like 50% of meals deduction.
- Depletion for oil and gas property up to the amount of that property's adjusted basis.
- Ordinary losses.
- Separately stated losses on Schedule K-1 (1120-S), boxes 2–10, 14P, 14Q.

However, these items only reduce debt basis to the extent that they were not used to offset any items that increase stock basis. There is a Worksheet for Figuring a Shareholder's Stock and Debt Basis in the Shareholder's Instructions for Schedule K-1 (Form 1120-S) that can be used to calculate the shareholder's debt basis, if you don't want to work with a tax professional to keep track of it for you.

### **Shareholder Loss Limitations**

All right, let's talk about the other reason for keeping track of your basis and the one that is currently on the IRS's radar. Just because the Schedule K-1 (1120-S) reports a loss does not mean that the shareholder will be able to claim the loss on their personal return.

Before the loss can be claimed, the shareholder must apply four loss limitations rules. The limitations are (in order of how they are applied):

1. *Stock and Debt Basis Limitations.*

This is the rule that the IRS is ramping up audits on, because so many people have not been following it. It states that a loss from a passthrough cannot take a loss in excess of their stock and debt basis. This is why it is the responsibility of each shareholder to recalculate their basis at the end of each of the corporation's tax year - or work with a tax professional to create the basis worksheet(s). The losses that are disallowed by this limitation may be carried forward to future years indefinitely until there is enough profits to subtract them from.

2. *At-Risk Limitations.*

If you pass the first rule, then you have to apply the At-Risk Limitation rules, which states that a shareholder's losses are limited to the amount that they might actually lose in the

business. For instance, if you borrowed money to buy stock or make a loan to the corporation with a nonrecourse debt, you can't deduct the loss against that amount. This is because a nonrecourse loan doesn't have to be paid back, so you would not be out any money if the corporation defaulted on it. Instead, you would have to *Form 6198, At-Risk Limitations*, with the return to calculate how much of the loss you can take. While this situation is rare, you should be aware of it.

### 3. *Passive Activity Limitations.*

This has to do with shareholders that do not work for the corporation, but are simply investors. Since they do not materially participate in the business, the loss is considered from passive activities and the loss must be carried over each year until such time that there are profits from the corporation to subtract them from or unless there is other income from passive sources such as rental income or the stock is sold. An exception applies when the business is a rental activity in which the shareholder actively manages. In that case, a special allowance of up to \$25,000 of loss is allowed.

### 4. *Excess Business Loss Limitations.*

For tax years 2021 through 2025, there are additional restrictions on excess business losses incurred by noncorporate taxpayers (like partners or stockholders). This used to only apply to farmers. Under these rules, total business losses on a shareholder's personal return are limited to the sum of the following:

- A. The total income or gain from trades and businesses on the return and
- B. \$250,000 (\$500,000 MFJ) which is adjusted annually for inflation

While this will not apply to most small businesses, should you be wildly successful, you should know that the excess loss limited by this rule is treated as a net operating loss (NOL) and carried forward indefinitely.

## **Form 1120-S**

S corporation need to file each year tax form 1120-S. S-corporation federal tax returns are due on 15th day of the third month after the end of the fiscal year. For calendar year S-corporations, that would be March 15th, unless a six month extension is filed.

Much like the partnership return, it is an information return since no income tax is paid at the corporate level and it must produce K-1s for each shareholder with their share of profits, losses, and separately stated items.

Although we won't go through the entire return process, I want to highlight some things and discuss parts of the return we have not addressed in other modules in this course.

On page one, the compensation of officers (reported on Form W-2) is listed separately from other employee salaries and wages. The rest of the page lists the non-separately listed items. Make sure you use the appropriate line for the expense if there is one. The "other" line should be only for their expenses at do not fit into one of the standard categories.

Schedule K takes up pages 3 and 4. This is where the profit and loss from page one, along with all of the other separately stated items are listed. The tax theories you studied under partnerships about separately stated items apply here also.

The first section lists all income, both ordinary income (calculated on page 1) and separately stated items of income. Separately stated items can be described as any tax item that may affect the individual shareholder's income tax returns differently. These include passive income, investment income, and capital gain (loss).

The next two sections of Schedule K are the separately stated deductions and credits.

The last five items on the Schedule K are Foreign Transactions (line 14), Alternative Minimum Tax Items (line 15), Items Affecting Shareholder Basis (line 16), Other Information (line 17), and Reconciliation (line 18).

### **Form K-1 (1120-S)**

The K-1s for each of the shareholders are created by dividing up these figures by the percentage of ownership in the corporation, just like partnerships do for their partners.

#### *Part I*

Part I of Schedule K-1 (Form 1120) is general information about the S corporation, including the corporation's EIN, the name and address, and the IRS Center where the corporation filed the return.

#### *Part II*

Part II of Schedule K-1 (Form 1120-S) is general information about the shareholder, including the shareholder's identifying number, their name and address, and the shareholder's percentage of stock ownership for the year.

#### *Part III*

Part III corresponds to the information on Schedule K of Form 1120-S and includes the individual shareholder's share of income and deductions.

Just like sole proprietors and partnerships, for tax years beginning in 2018 through 2025, the Tax Cuts and Jobs Act (TCJA) allows a qualified business income (QBI) deduction of 20%. It is

taken at the shareholder level and is calculated on each shareholder's tax return using information from the shareholder's Schedule K-1 (Form 1120-S).

Shareholders will see code V in box 17 of their Schedule K-1 (Form 1120-S), indicating *Statement A* is attached which contain the information they need to claim the deduction.

### **Additional Sections of the 1120-S**

The final section of the tax return is used by the IRS to verify the accuracy of the tax reporting because analyzing the changes from the beginning to ending balances recorded in the Balance Sheet should be consistent with the income being reported on the tax return and reconciled on Schedule M-1 as well as the equity accounts being analyzed on Schedule M-2. These three schedules (Schedule L, M-1 and M-2) are inter-connected and a change or adjustment to one of these schedules can affect the other schedules. The Balance Sheet also contains information that would indicate to the IRS that certain income items or deductions should be present on the tax return.

Not all corporations have to submit a balance sheet, and many smaller corporations do not complete Schedule L. However, when a corporation is required to submit a balance sheet with the tax return, it is critical to submit an accurate balance sheet that is consistent with the other items reported on the tax return.

A corporation does not have to complete these additional sections if it meets BOTH of these conditions:

- The corporation's total receipts were less than \$250,000 for the tax year, and
- The corporation's total assets were less than \$250,000 at the end of the tax year

If both conditions are met, the corporation can opt out of completing Schedule L and Schedule M-1. To opt out of completing the schedules by going to Schedule B – Other Information > Receipts and Assets at year end less than 250,000 and saying Yes on the checkbox.

Because of this quarter million dollar exception, these additional sections may not apply to a lot of small corporations, but I want to briefly go over them for when you get to that point in your business.

If the corporation does **NOT** meet both requirements, the corporation is required to complete Schedule L and enter the balance sheet as reflected on the corporation's books and records. As a practical matter, Schedule L - (Balance Sheet) should be entered before attempting to complete either Schedule M-1 (Reconciliation of Income) or Schedule M-2 (Analysis of

Accumulated Adjustment Accounts) because certain items calculated on those schedules reconcile with items on the balance sheet.

We discussed balance sheets in Module 2.5 and Schedule L is where that information is entered on the tax return. Often, businesses will depreciate assets differently on their books than on their tax returns. You will account for those differences on either line 3a or 6a of Schedule M-1, depending on whether the corporation took more or less depreciation than is taken on the tax return.

If the book depreciation is greater than the tax depreciation (MACRS), the difference will be added to the book income. The entry would be made on line 3a. If depreciation for tax (MACRS) is greater than the book depreciation expense, the difference will need to be subtracted from the book income and entered on line 6a. Additionally, any Section 179 expense taken on the tax return that is not taken on the books will require an entry on line 6.

If you read through the instructions on some accounting software packages, they advise you to print out the balance sheet, then do your tax return figuring what the tax depreciation is, then go back into your accounting software and enter that depreciation in, before you close out the books for the year. This way the depreciation matches on both. Now, a good accountant will tell you that is not the proper way to do it because accepted accounting procedures do not allow MACRS depreciation, but only straight-line depreciation. This is why it needs to be reconciled on the Schedule M-1.

So, if you have depreciable assets, then before buying an accounting software package, it is a good idea to find out if it calculates depreciation for you or if you have to enter it by hand.

**Schedule M-1** starts with the income per the books on line 1. As the title states, this is a reconciliation between the books (the corporation's financial records) and the tax return. We start with the income (loss) per the books. While there are many other items of income and expense that may require an entry on the Schedule M-1, we will cover the most common ones here:

- Any travel, entertainment, gift, or meal expense that has been included on the books at 100% of the expense, but is not deductible on the tax return due to limitations (such as the 50% meal expense limitation), should be included on line 3b.
- Interest and other expenses related to a loan to acquire tax-exempt bonds, political contributions, tax penalties, illegal fines paid, bribes, and protection payments are included on the books, but not deductible for tax.
- Tax-exempt interest income is included in book income calculations but is excluded from taxable income. If tax-exempt interest is not included on Schedule K, enter the amount on line 5.

- There may be a difference between the tax and book basis of some, or all, assets because of previously deferred gains or tax credits. Gain on the sale of an asset may require adjusting the entry on line 5.

While a good tax software will automatically fill in some of these differences like the 50% meal deduction, any differences like tax-exempt interest which are not even listed as an expense on the return have to be added manually.

You will find the income per books on line 8, on the corporation's income statement and the reconciled income per return on Schedule K, line 18. So, you can verify that the schedule is correct by comparing the numbers on lines 1 and 8 of Schedule M-1 to the net income on the income statement and line 18 of Schedule K.

### **Schedule M-2**

Schedule M-2 provides analysis of three separate accounts: the accumulated adjustment accounts (AAA), the other adjustments account (OAA), and the shareholder's undistributed taxable income previously taxed (PTI).

The AAA is generally only required for S corporations that used to be C corporations and have accumulated earnings and profits from their time as C corporations. A corporation that was an S corporation from day one does not have to complete this.

### **Corporations Owning Corporations**

While partnerships have a lot of flexibility in how they are structured, there are also some options when it comes to S corporations. As your business grows, it may make sense to create a subsidiary for operating efficiency. The Internal Revenue Service has created the qualified Subchapter S subsidiary (QSub) rules to address this situation. (Remember that there is no limit on earnings for S-Corporation status, only a limit of 100 shareholders and one class of shares.) This rule allows a growing company the ability to open a subsidiary without losing its S status.

A subsidiary also qualifies as an S-corporation if:

- 100 percent of the stock is owned by the parent corporation;
- The parent corporation's shareholders hold the subsidiary's shares directly; and
- The parent corporation files for qualified subchapter S (QSub) status for the subsidiary.

The election to be treated as a Qsub is done by filing Form 8869, Qualified Subchapter S subsidiary Election and is effective on the date specified on the election form.

For tax purposes, the QSub doesn't exist. All of its income, deductions, profit or loss is considered to be the parent corporations. It is as if the subsidiary were liquidated and all the

assets merged into the parent. This gives you the tax advantages of the S-corporation, while having the flexibility to manage your business needs.

### **One Last Thing**

There are additional considerations when switching a C corporation that has been in existence for several years to an S corporation. If the C corporation has a carry-over loss, it cannot be carried over to the S corporation. The loss would be retained until such time as the S-election was cancelled and the business became a C corporation again. So if the C corporation has a sizable carry-over loss, it may be better to wait until that is used before making the switch.