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MiSEA**

**Presents**

**Form 1120-S Corporation Issues**

**at the**

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## I. Subchapter S-Corporation

### A. Pass Through Entity

1. In 1958 Congress passed the Small Business Corporation Act which created an entity for tax purposes which would help safeguard the family owned business allowing legal protection and the pass-through of profits and losses to the individual owners without incurring taxes at the corporate level and again through the distribution of dividends to the owners of the family-owned business.
2. It also allowed the use of the business loss to be passed down to the owners instead of being locked in at the entity level. It was truly for small family businesses and the number of shareholders was limited to **5** individuals.
3. In terms of the manner in which it functions for **non-tax issues** a Subchapter S-Corporation is just like a Subchapter C-Corporation. An S-Corporation combines the business and legal characteristics of a C-Corporation.
4. S-Corporations have the features of:
  - a. limited liability for the owners,
  - b. operates with a management group, and
  - c. has a board of directors and officers.
5. S corporations differ from C Corporations in regard to income tax matters. An S corporation is a "pass through" entity. It has many of the federal income tax characteristics of a partnership. The corporation acts as a conduit through which the tax attributes flow through to shareholders on a *pro-rata* method. Large and public companies generally cannot elect S-Corporation status. Many small businesses have made it the entity of choice.
6. Double taxation of corporate earnings is avoided because there is generally no corporate-level income tax. Earnings are taxed only once at the shareholder level in the year when earned (regardless of when they are distributed).

7. **§6072(b)** provides that an S-Corporation must file an annual return on IRS **Form 1120S**, *U.S. Income Tax Return for a Corporation* by the 15<sup>th</sup> day of the third month following the close of the corporation's tax year. The law provides that the return must be filed until liquidated. Therefore, even if there is no activity in the current tax year the return is required to be filed.

**Tax Professional Red Alert:** There is a monthly penalty for the failure to file a **Form 1120S**. **§6699** provides an S Corporate level penalty of **\$205** per shareholder per month or fraction of a month up to 12 months for the failure to file an S-Corporation return. The provision is indexed annually to inflation.

8. An automatic 6-month extension is granted for filing the **Form 1120** by filing IRS **Form 7004** by the 15<sup>th</sup> day of the 3<sup>rd</sup> month after the end of the tax year. The Form Code is **25**.
9. **§6722** provides for a **\$260** corporate level penalty per shareholder for failure to provide **Schedule K-1** to shareholders or failure to include all the required information. This provision is indexed annually to inflation.

## **B. Formation**

1. Since a Subchapter S-Corporation is only a filing status for Federal Income Tax purposes the formation of the corporation is dictated by state statute the same way as is a regular C-Corporation. Therefore, the same formalities are required such as:
  - Written Corporate Charter
  - Articles of Incorporation
  - Adoption of Written By-Laws
  - Election of a Board of Directors
  - Holding of Organizational Meetings
  - Written Minutes of Organizational Meetings
  - Stock Certificates
  - Franchise Fees
  - Registered Agent

2. The significant difference between a Subchapter S-Corporation and a regular C-Corporation is that a formal *election* must be made by the corporation to be treated as a Subchapter S-Corporation for Federal Income Tax purposes.

**Note:** The *election* is valid only if all shareholders *consent* to the "election."

### **C. Form of Consent**

1. **§1362(a)(2)** provides that **all** shareholders **must consent** to the election by signing **IRS Form 2553**, *Election by a Small Business Corporation*. The required consent may be provided on the **Form 2553** or on a separate statement attached to the election. Once made, an election continues until a disqualifying act or shareholders affirmatively revoke the election.
2. **§1362(b)(2)** requires that the *election* must be filed with the Service by the **15th day of the third month of the taxable year** in which the election is to take effect. The election must be signed by a person authorized to sign the corporation's tax return.
3. The corporation must meet all of the eligibility requirements for the pre-election period of the tax year, and all persons who were shareholders during the pre-election period also must consent to the election.
4. **§1362(b)(3)** provides that if the election is filed **after** the 15th day of the third month then the S-Corporation status does not take effect until the beginning of the following tax year.

### **D. No Double Taxation**

1. The most significant advantage in electing the S-status is the single level of federal income taxation. There is no corporate level tax.
2. The taxation of corporate profits is assessed only once at the individual shareholder's level.

**EXAMPLE #1:** Two corporations both have net taxable income of \$100,000.

	<u>C-Corporation</u>	<u>S-Corporation</u>
Net Income	\$100,000	\$100,000
Less: Corporate Tax	<u>(22,250)</u>	( -0- )
Balance Available to Shareholders	<u>\$ 77,750</u>	<u>\$100,000</u>

**NOTE:** The income tax result of the balance available to shareholders will depend on each shareholder's tax rate vs. the 0%, 15% or 20% qualified dividend rate.

- An S-corporation is a "pass-through" entity. It is a conduit through which all profits, losses, deductions, credits, etc. flow through to the shareholders on a pro-rata method (per share, per day allocation).

**EXAMPLE #2:** Based on the results in Example #1 above, Don is a **20%** shareholder of the S-Corporation and he owed his stock for only **120** days during the current tax year. As a result his per-share per day allocation reported on his **Schedule K-1** is calculated as follows:

$$\$100,000 \times 20\% \times 120/365 = \$6,575$$

If he owned **20%** for **120** days and then acquired another **5%** for **20** days then the allocation would be as follows:

$$\$100,000 \times 20\% \times 120/365 = \$6,575$$

$$\$100,000 \times 5\% \times 20/365 = \underline{1,370}$$

: Total reported on **Schedule K-1** \$7,945

- If new corporations are expected to generate **losses** in the early years then the use of the S-corporation is often preferable to a C- corporation because losses from an S-corporation flow through to shareholders and can be used to offset other income of the shareholders and their spouses if a joint income tax return is filed.

**EXAMPLE:** Two corporations both have **net taxable losses** of \$50,000.

	<u>C-Corporation</u>	<u>S-Corporation</u>
Net Loss	\$(50,000)	\$(50,000)
Other Sources of income	<u>-0-</u>	<u>50,000</u>
NOL Carryforward	\$( <u>50,000</u> )	<u>-0-</u>
<b>Deduction Current Year</b>	<u>\$ -0-</u>	<u>\$ 50,000</u>

5. A shareholder may not be able to claim a loss in a current year if the loss is prohibited by another provision in the Code such as **§469** passive activity loss rules. Also a taxpayer cannot claim a deductible loss if there is insufficient basis in stock.

**EXAMPLE:** Don owns stock in an S-Corporation which reports a loss of \$20,000. Don owns **25%** of the stock. His pro-rata share is \$5,000. However, he can deduct only \$3,500 because his basis in his stock is \$3,500. The excess \$1,500 is deferred.

#### **E. Property Distributions By An S-Corporation**

1. When dealing with property distributions by an S-Corporation the distribution is a deemed sale.

Gain is measured at the corporate level using the following formula:

**FMV of Asset on Distribution Date**

**Less: Adjusted Basis of Asset**

**Equals: Corporate Level Gain**

2. An advantage of an S-corporation over a C-corporation is that the gain is not taxed at the corporate level.
3. The gain is **passed through** to the individual shareholders based on their pro-rata allocation on **Schedule K-1**. Therefore, the tax is imposed only once.

4. The **gain** recognized by the shareholder **increases** their individual **stock basis**.
5. The **character** of the gain is dependent on the character of the property in the hands of the S-corporation.

**Tax Professional Note:** Losses on distributions of property are not recognized.

**EXAMPLE:** A Subchapter S-Corporation has an asset with an FMV of **\$14,000** and an adjusted basis of **\$8,000** which is distributed to Don a **50%** shareholder. Don's stock basis prior to the distribution is **\$10,000**.

**Corporate Level:**

FMV of property	\$14,000
<u>Less: Adjusted Basis</u>	<u>( 8,000)</u>
<u>Corporate Gain</u>	<u>\$ 6,000</u>

**Shareholder Level:**

Stock Basis Prior to Distribution	\$10,000
<u>Add: 50% of Corporate Gain - Schedule K-1</u>	<u>3,000</u>
<u>Adjusted Basis Prior to Distribution</u>	<u>\$13,000</u>
FMV of Property Received	\$14,000
<u>Less: Adjusted Basis of Stock</u>	<u>(13,000)</u>
<u>Capital Gain</u>	<u>\$ 1,000</u>

**F. Shareholder's Basis in the S Corporation Stock: Determining Initial Basis**

1. The **starting point for calculating basis** in a conduit entity is to determine **initial basis** depending on whether the owner acquired the interest by purchase, capitalization of a newly-formed entity, gift or inheritance.
  - **Acquisition by purchase:** §1012 states that the shareholder's basis will be the purchase price of the stock on the date of acquisition: **cost**.

- **Acquisition in exchange for contributed property:** §351 provides that the initial basis will be the adjusted basis of the assets given up in exchange for the stock: **carryover basis**.
  - **Acquisition by gift:** §1015 provides that the *donor's* basis will be transferred to the donee: **carryover basis**.
  - **Acquisition by inheritance:** §1014 provides that the shareholder's stock basis will be stepped up at date of the decedent's death: **fair market value**.
2. Once the taxpayer determines the **initial basis**, it is adjusted each year. Generally basis adjustments are calculated at the close of the S-Corporation's taxable year.
  3. There are **two exceptions** to this year-end calculation rule:
    - a. If the S-election is terminated or revoked then the S-Corporation is required to treat the tax year as consisting of two separate years for purposes of allocating items to the shareholders;
    - OR**
    - b. When a shareholder disposes the stock during the year, the basis for gain or loss is determined as of the day *before* the ownership interest is sold.

As a result, the basis adjustments are made as if the year consisted of several separate tax years.

**G. Annual Adjustments that Increase Stockholder Basis**

1. §1367(a)(1) provides that a shareholder's S-Corporation stock basis is increased by:
  - a. **Non-separately** stated ordinary income passed through by the S-Corporation as a result of its operations;
  - b. **Separately** stated items of income passed through by the entity whether taxable or not; and
  - c. Any subsequent **contributions of capital** by the shareholders to the corporation.

**Tax Professional Reminder:** It is important to note that if an item of *taxable income* that should have been included as income on the return was not included in the gross income, then that item does not increase the shareholder's stock basis.

## H. Annual Adjustments that (Decrease) Stockholder Basis

1. §1367(a)(2) provides that a shareholder's S-Corporation stock basis is decreased by:
  - a. **Non-separately** stated ordinary loss passed through by the S-Corporation as a result of its operations;
  - b. **Separately** stated items of loss and expenses;
  - c. Nontaxable **distributions** to the shareholder; and
  - d. **Nondeductible** expenses not properly chargeable to a capital account, (such as meals, political contributions, penalties, etc.).

**Tax Professional Reminder:** The basis of the shareholder's stock is decreased by the amount of any loss or deduction that is *allowed* for the taxable year, **regardless** of whether the loss or deduction is disallowed or deferred under another provision of the Internal Revenue Code, such as the passive loss rules under §469.

**Tax Professional Reminder:** The annual adjustments to the stockholder's basis are generally made at end of the entity's tax year and have specific ordering rules.

2. §1367(b)(2) provides that if a shareholder's stock basis is reduced to zero, then the remaining net decrease attributable to losses and deductions is applied to reducing the basis in any debt owed to the shareholder by the S-Corporation.

**Tax Professional Reminder:** Distributions may not be applied against basis in debt.

3. Any net increase in basis in a subsequent year is first applied to **restore debt basis** before stock basis.

**Tax Professional Reference:** There are detailed rules stated in IRS Reg. §1.1367-2 pertaining to adjustments in the basis of a shareholder's corporate debt basis.

## I. Entity Debt Does Not Create Basis

1. A shareholder's basis is not increased by the shareholder's pro-rata share of the S-Corporation debt.
2. This is true even if the shareholder has guaranteed the debt.
3. The reason is that there is no increase in basis unless the shareholder has an actual economic outlay.
4. If a shareholder wants to create basis then the shareholder should make an actual loan to the corporation.
5. If the shareholder does not have the money then shareholder should borrow the money directly from a bank and lend it to the corporation.

**Tax Professional Note: Letter Ruling 8747013** provides that money **loaned by the bank** to the shareholder, and subsequently **lent by the shareholder** to the corporation, will constitute debt basis assuming all of the following are met:

- a. The **stockholder is personally liable** for the bank loan;
- b. The **corporation is not a guarantor or co-maker** on the loan;  
and
- c. The **interest rate** on the bank's loan to the stockholder is at the **bank's current rate**.

### **Debt Substitution:**

Another technique is to **restructure the debt** of the corporation. **Revenue Ruling 75-144** provides shareholders with additional basis when the shareholders guarantee obligations of the corporation and **substitute their own notes for those of the corporation**. This is true **provided the creditor relieves the corporation from its liability** on the old note **and substitutes the shareholders** as the primary obligors.

This lack of basis creation at the entity level is a great disadvantage of an S-corporation as opposed to the **favorable treatment of entity debt available for creating basis for partners of a partnership**.

## **J. Employment Issues of an S-Corporation Shareholder:**

1. Subchapter S Corporation shareholders who are actively involved in the daily operations of the business are subjected to the employment provisions of the Code. The employer should pay a reasonable salary and withhold income taxes, social security and medicare and pay the required employer matching. The shareholder employee salaries are also included for purpose of FUTA and SUTA.
2. Unreasonably low wages relative to services provided can be challenged by the Service, causing the excess profits to be recharacterized as wages and subjected to additional social security and medicare taxes. In addition there will be interest assessed as well as penalties for failure to pay and failure to file employment tax returns.
3. **§3121** provides that wages are defined as all remuneration for employment.
4. **§3121(d)** provides a definition of employee to include any officer of a corporation.

**Tax Professional Note: Reg. §31.3121(d)-1(b)** allows an exception to the employee status for an officer who performs no services or only minor services to the corporation.

## **K. Establishing Reasonable Compensation**

1. In order for compensation to be deductible, it must be reasonable for the services actually rendered. The Code specifically empowers the IRS to reallocate an S corporation's income in family income-splitting situations.
2. **1366(e)** provides that a member of an S corporation shareholder's family must receive reasonable compensation for services rendered or capital furnished to the corporation. This provision applies to family members whether or not they own shares in the corporation.

**Tax Professional Note:** The instructions to the Form 1120S, state: "Distributions and other payments by an S Corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation."

3. Under these rules, the Service can adjust income to reflect reasonable compensation for services rendered or capital furnished to the corporation. In addition, rent and interest payments to shareholders or family members could be reallocated by the IRS if ruled unreasonably high.
4. There is no definition for reasonable compensation. Each situation must be resolved based on its unique facts and circumstances.

**Several Tax Court decisions have focused on these factors:**

- The character and financial condition of the corporation,;
- The role the shareholder-employee plays in the corporation, including position, hours worked and duties and responsibilities;
- Training and experience;
- The corporation's compensation policy for all employees and the shareholder's salary history, including the internal consistency in establishing the shareholder's salary;
- How the compensation compares with similarly situated employees of other companies;
- Timing and manner of paying bonuses to key employees;
- Whether a hypothetical, independent investor would conclude that there is an adequate return on investment after considering the shareholder's compensation;
- Compensation agreements;
- The employee's qualifications and education;
- The size and complexity of the business;
- The use of a formula to determine compensation;
- A comparison of salaries paid in relation to sales and net income;
- General and specific economic conditions of the country, geographic area and the industry;
- Salaries versus distributions and retained earnings;

- Compensation paid in prior years;
- The corporation's earning and distribution history;
- Whether employee and employer dealt at arm's length and
- Whether employee guaranteed employer's debt.

No single factor controls, but rather a combination of the factors must be considered. Furthermore, these factors are not all-inclusive (and may not be given equal weight).

5. The Service's position as to the key for establishing reasonable compensation is determining what the shareholder-employee did for the S Corporation. The Service instructs its auditors to look to the source of the S Corporation's gross receipts and they specify 3 major sources as follows:
  - a. Services of shareholder,
  - b. Services of non-shareholder employees, or
  - c. Capital and equipment.

If the gross receipts and profits come from items 2 and 3, then that should not be associated with the shareholder-employee's personal services and it is reasonable that the shareholder would receive distributions along with compensations.

On the other hand, if most of the gross receipts and profits are associated with the shareholder's personal services, then most of the profit distribution should be allocated as compensation.

In addition to the shareholder-employee direct generation of gross receipts, the shareholder-employee should also be compensated for administrative work performed for the other income producing employees or assets. For example, a manager may not directly produce gross receipts, but he assists the other employees or assets which are producing the day-to-day gross receipts.

# **III. EXHIBITS**

## COMPARATIVE ANALYSIS

<u>Item</u>	<u>Sole Proprietorship</u>	<u>Partnership</u>	<u>C Corporation</u>	<u>S Corporation</u>	<u>Limited Liability Company</u>
1. Method of Formation of Entity	Obtain necessary business licenses.	Partnership agreement written or oral.	Filing of articles incorporation: must qualify to do business with IRS in appropriate states	Same as C corporation; also must file election (and in some cases with state) to be taxed as an S corporation.	Articles of organization filed in state recognizing LLCs.
2. Liability	Unlimited personal liability for debts of the business.	General partners are jointly and severally liable: limited partner's liability generally limited to capital contributions	Shareholders' liability limited to amount of capital contributions.	Same as C corporation.	Same as C corporation.
3. Management of Enterprise	Proprietor is responsible for all management decisions.	General partners can engage in active management of business: limited partners lose limited liability if actively participating in management.	Management is centralized in board of directors: shareholders can actively participate in management as officers or directors.	Same as C corporation.	May be vested in members or elected non-member managers.
4. Ability to Transfer Interests in Entity	Transfer assets of business.	General partner can only transfer his interest with approval of all partners (unless agreement provides otherwise). Limited partners may typically transfer interests only with consent of general partners.	Generally unrestricted (unless agreement to the contrary).	Same as C corporation, but can only transfer interests to eligible shareholder if S election to be retained.	Generally requires unanimous consent.

<u>Item</u>	<u>Sole Proprietorship</u>	<u>Partnership</u>	<u>C Corporation</u>	<u>S Corporation</u>	<u>Limited Liability Company</u>
5. Tax Rules Governing Formation of Entity	No gain or loss recognized on the formation of the business.	Generally, no gain or loss is recognized on contribution of property to a partnership in exchange for a partnership interest.	Generally, no gain or loss on transfer of money or property in exchange solely for stock if after the transfer the transferors control the corporation.	Same as C corporation.	Same as Partnership.
6. Limitations to Ownership	Limited to one individual.	No restrictions on who can be an owner, but need at least two owners and at least one must be a general partner.	No limitations on the type or number of persons who can hold stock.	Limited to 100 shareholders who are individuals, estates, and certain trusts. Can only have one class of stock.	Same as C corporation.
7. Entity-Level Taxation	Form 1040-Schedule C	Partnership itself is not a separate tax-paying entity. Items of income, loss, etc. are passed through to owners.	Entity-level tax is imposed on the corporation's taxable income.	Generally not subject to corporate-level taxes.	Same as partnership.
8. Allocation of Profits and Losses	Only one answer.	Flexibility in allocating items of income loss, etc. so long as allocations have substantial economic effect.	No allocation allowed.	Items of income or loss allocated to shareholders on a per-share, per-day basis.	Same as partnership.
9. Limits on Utilization of Losses	Losses reported directly on owner's individual tax return subject to normal limits	Potential limitations include basis limitation, at-risk rules and passive activity loss rules. Basis can include partnership debt to third parties.	Only the corporation can utilize losses by either carrying them back or forward.	Shareholders may use losses but are subject to basis limitation. Shareholders cannot increase basis due to debt of corporation.	Same as partnership.

<u>Item</u>	<u>Sole Proprietorship</u>	<u>Partnership</u>	<u>C Corporation</u>	<u>S Corporation</u>	<u>Limited Liability Company</u>
10. Liquidation of Entity (Property Distribution)	Asset by Asset	Partnership and partners generally recognize no gain or loss on a liquidating distribution; partners recognize gain to extent they receive money in excess of basis in their partnership interests.	Corporation generally recognizes gain or loss as if assets were sold at fair market value. Shareholders generally recognize gain to extent value of assets received exceed stock basis. Recognize capital loss if value of property received is less than shareholder's stock basis. Loss is ordinary to the extent §1244 applies.	Same as C corporation except that corporate gain on liquidation passes through to shareholders and only taxed once.	Same as partnership
11. Tax Treatment of Cash Distributions	No tax on cash withdrawn from the business.	Partners taxed only on cash distributions in excess of partner's basis in his partnership interest. Generally such distributions are treated as capital gains.	Dividends to shareholders are taxed as ordinary income. To the extent of corporation's "E&P".	Distributions to shareholders are tax-free to extent of AAA and distribution does not exceed shareholder's stock basis. Distributions in excess of shareholder's stock basis are reported as capital gain. Distributions taxable as dividends if out of "AE&P" of old C-Corp.	Same as partnership.

<u>Item</u>	<u>Sole Proprietorship</u>	<u>Partnership</u>	<u>C Corporation</u>	<u>S Corporation</u>	<u>Limited Liability Company</u>
12. Tax Treatment of Property Distributions	Taxed to extent of recapture.	Generally no gain or loss on distribution of property other than money to a partner.	Corporation generally recognizes gain on distribution of appreciated property. Transaction treated as if the corporation sold the property for its fair market value. Shareholders generally report receipt of property as a taxable dividend to extent of corporation's E&P.	Corporation recognizes gain on distribution of appreciated property to a shareholder, but gain passes through to shareholders. Distributions are tax-free to shareholders depending upon the corporation's AAA, AE&P, and the shareholder's basis in the stock.	Same as partnership.
13. Sale of Interest in the Entity	Cannot sell equity interest; sale of business is viewed as a sale of each asset.	Partner can sell interest in the partnership generally resulting in a capital gain or loss.	Shareholder who sells stock generally has a capital gain or loss; sale of §1244 stock may result in ordinary loss.	Same as for C corporation.	Same as partnership.
14. Sale of Assets by Entity	Recognize gain or loss separately on each asset sold.	Gains or losses from sale passed through and taxed once at partner level.	Corporate level tax is imposed on gains and losses recognized on sale of assets. A shareholder-level tax is also imposed when sale proceeds are distributed.	Gain or loss on sale of an asset passes through to the shareholders.	Same as partnership.

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## Summary of Shareholder's Basis

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### Increases

Original cost of shareholder's stock

Shareholder loans to S corporation

Separately stated income/gain

Non-separately stated income/gain

Excess depletion deductions over basis of property being depleted

Additional capital contributions or stock purchases

### Decreases

Distributions that are a return of basis

Repayment of shareholder loans by S corporation

Separately stated losses/deductions

Nondeductible expenses not properly chargeable to capital account

Depletion deduction for oil and gas wells, to extent of shareholder's basis in depletable property

Distributions not in excess of basis

# Statement of Revocation of S Election

Date \_\_\_\_\_

Internal Revenue Service Center

\_\_\_\_\_  
\_\_\_\_\_

RE: \_\_\_\_\_

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Please be advised that the above corporation hereby revokes the Subchapter S election it made under Section **§1362(a)** of the Internal Revenue Code. This revocation is intended to be effective on \_\_\_\_\_. The corporation has \_\_\_\_\_ shares of stock issued and outstanding at this time.

A statement signed by more than 50% of the corporation's shareholders consenting to the revocation is attached.

Sincerely,

\_\_\_\_\_  
Title of Authorized Signor  
of Tax Return

## Statement of Consent of Revocation of the S Election

The undersigned, as shareholders of The \_\_\_\_\_ Corporation, EIN \_\_\_\_\_ on \_\_\_\_\_, the date of revocation by that corporation of its election under **§1362(a)** to be an S corporation, hereby **consent to that revocation**. The shareholders are calendar year taxpayers. They acquired their shares in the corporation on \_\_\_\_\_.

Under penalties of perjury, we declare that the statements made herein are to the best of our knowledge and belief, true, correct and complete.

Name, Address and Social Security No. of Shareholder	Number of Shares Held at Time Revocation is Made	Date of Signature	Signature
--	--	----------------------	-----------

X\_\_\_\_\_

X\_\_\_\_\_

**Statement of Consent to Rescind the Revocation  
of the S Election**

The undersigned, as shareholders of The \_\_\_\_\_ Corporation, EIN \_\_\_\_\_ on \_\_\_\_\_, the date that is elected to rescind the revocation of its S corporation election under **§1362(a)** hereby consent to that rescission. The shareholders are calendar year taxpayers. They acquired their shares in the corporation on \_\_\_\_\_.

Under penalties of perjury, we declare that the statements made herein are to the best of our knowledge and belief, true, correct and complete.

Name, Address and Social Security No. _____ of Shareholder	Number of Shares Held at Time Revocation is Made	Date of Signature	Signature
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X\_\_\_\_\_

X\_\_\_\_\_

# Election Not To Apply Pro Rata Allocation

**Corporation** \_\_\_\_\_

**EIN** \_\_\_\_\_

**Tax Year** \_\_\_\_\_

The corporation elects (with the consent of all shareholders during the short S year and all shareholders on the first day of the C year under §1362(e)(3) not to apply the pro rata allocation method of 1362(e)(2) for determining the amounts of income, expense, and credit to be allocated to the S short period ended \_\_\_\_\_ and to the C short period ended \_\_\_\_\_. The corporation elects to close its books as of \_\_\_\_\_ and to take into account under normal tax accounting rules the specific transactions that apply to each short period.

Cause of S Termination: \_\_\_\_\_

Date of Termination: \_\_\_\_\_

Date: \_\_\_\_\_

By: \_\_\_\_\_

Authorized Officer

## Consent of Shareholders

The following shareholders, constituting each of the shareholders of the corporation during the S short period and each person who was a shareholder of the corporation on the first day of the C short year consent to the above corporate election.

**Date**            **Shareholder Signature**            **Social Security Number**  
\_\_\_\_\_

## PER-SHARE, PER-DAY ALLOCATION METHOD

The pro rata method assigns an equal amount of each of the S items to each day of the year. If a shareholder's stock holding changes during the year, then the per-day method assigns the shareholder a pro rata share of each item for *each* day the stock is owned:

**S Corporation item**    **X**    **Percentage of Shares Owned**    **X**    **Percentage of Year Owned**    **=**    **Amount of item to be reported**

## Subchapter S Corporation Checklist:

		<u>Yes</u>	<u>No</u>
1.	Is the entity incorporated?	_____	_____
2.	If incorporated did the entity file a timely <b>Form 2553</b> ?	_____	_____
3.	If not incorporated is the entity an LLC that filed <b>Form 8832</b> ?	_____	_____
4.	Are all shareholders eligible to own Subchapter S stock?	_____	_____
5.	Should bonuses be paid to employee shareholders before year-end?	_____	_____
6.	Before making a <b>§179</b> election did you verify that shareholders will be able to use the full pass through amount?	_____	_____
7.	If there is a current year loss do shareholders have sufficient basis to utilize loss?	_____	_____
8.	Do shareholders have sufficient stock basis to avoid distributions treated as capital gains?	_____	_____
9.	Is the entity using property of the owners which should be treated as a lease agreement (Rental of building or equipment)?	_____	_____
10.	Have shareholders been reimbursed for out-of-pocket expenses paid on behalf of the entity? Is there an accountable plan in force?	_____	_____
11.	Are there employee benefit plans in force?	_____	_____
12.	Has any business property been distributed to shareholders?	_____	_____
13.	Do shareholders have a buy/sell agreement?	_____	_____
14.	Is there a need to revoke the S election?	_____	_____
15.	Have the basis of the assets transferred in the <b>§351</b> transaction been properly accounted for by the entity and shareholders?	_____	_____