S Corporation Income or Loss

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What is an S corporation?

An S corporation is a small business entity that is treated as a regular corporation for all purposes other than its treatment under tax law. To make a "subchapter S election," a corporation must satisfy a number of requirements:

- All shareholders must consent to the S corporation status
- The number of shareholders is limited to 100 (25 for tax years beginning prior to 2004)
- The corporation can issue only one class of stock
- The S corporation must be a domestic corporation, and its shareholders must be citizens or residents of the United States
- Only individuals, estates, S corporations and certain trusts can be shareholders of the S corporation

How is an S corporation taxed?

In effect, an S corporation conducts business as a regular corporation but is taxed similar to a partnership. Unlike a C corporation, the S corporation does not pay a corporate tax on income. Rather, the S corporation passes items of income, loss, deductions and credits through to its shareholders, who report the items and calculate the tax on their individual returns. Thus, the burden of taxation is shifted from the corporation to the individual shareholders.

Unlike a C corporation, an S corporation pays no regular income tax, alternative minimum tax, accumulated earnings tax or personal holding company tax.

What about double taxation?

One major advantage of the S corporation may be that it avoids double taxation. The term double taxation is often used in reference to a C corporation because a C corporation's corporate income is taxed once to the corporation when earned and again to the shareholders when distributed to them as dividends. In other words, the business profits are taxed twice, once at the corporate level and once at the individual level. Also, it is important to note that the corporation does not get a tax deduction when it distributes dividends to its shareholders.

Tip: Corporate income is taxed at 21%. Long-term capital gains and qualified dividends are generally taxed at 0%, 15% or 20%, depending on the amount of the individual's taxable income. An individual's tax rate on ordinary income can be as high as 39.6%. An additional 3.8% Medicare tax applies to some or all of the investment income for married filers whose modified adjusted gross income exceeds $250,000 and single filers whose modified adjusted gross income is above $200,000.

Example(s): Assume ABC Corporation has $1,000 worth of profits and that its only shareholder, Jack, pays tax on qualifying dividends at the rate of 15%. The corporate tax on $1,000 worth of profits amounts to $210. The remaining $790 will incur a tax of $118.50 when distributed to Jack, leaving only $671.50 in after-tax profits. This is an effective 32.85 % combined tax rate.

In contrast, the income of an S corporation is generally only taxed once when it flows through to the individual shareholders. However, if the S corporation was originally a C corporation with accumulated earnings and profits, it may be liable for a 35% flat tax on excess net passive income, certain capital gains and any built-in gains. For more information, contact an accountant or tax attorney.

How is taxable income determined?

Yearly tax return must be filed
Every corporation must file a yearly tax return, regardless of the amount of income or loss experienced. Filing ends only when the corporation has been totally dissolved. S corporations

must file Form 1120S by the 15th day of the 3rd month following the close of the corporation's tax year.

Subject to individual income rules — and sometimes partnership rules, too
Computation of gross income for an S corporation is similar to the computation of gross income for an individual taxpayer, although partnership rules will sometimes come into play. Each shareholder must report his or her proportionate share of separately and non-separately stated items of income, loss, deduction or credit.

Separately stated items
Because the S corporation is a conduit (pass-through) entity, it is required to separately list certain items that require separate reporting by the individual shareholders. The reason is that these items could affect the tax liability of different shareholders, depending on their particular tax situations. These items include:

- Long-term capital gain or loss
- Short-term capital gain or loss
- Charitable contributions
- Interest
- Dividends
- Royalty income

Corporation taxable income or loss
All other items (e.g., operating income) are combined at the corporate level and passed through to the shareholders. Thus, the S corporation must compute taxable income or loss, which consists of everything except the aforementioned separately stated items. Taxable income is determined by subtracting allowable deductions from gross income.

How are items allocated to shareholders?

Per share, per day basis
An S corporation must apportion each item of income, deduction, credit, etc., to its shareholders on a per share, per day basis using a weighted average. The corporation assigns an equal portion of the items to each day of the taxable year and then divides that portion pro rata among the shares outstanding on such day. The formula is as follows:

(S Corporation Item) x (% of Stock Owned) x (% of Year Stock Owned)

The calculation is easy if there was no change in shareholdings during the taxable year.

Example(s): Assume an S corporation has a 60% shareholder and a 40% shareholder. It has $70,000 in ordinary income, $20,000 in long-term capital gains and $5,000 in dividend income. The 60% shareholder will report 60% of each item, and the 40% shareholder will report 40% of each item.

Corporation reports required

The S corporation's ordinary income and deductions from its principal business activity are netted on Form 1120S, page 1. Other items are reported on Schedule K. All income, loss, deduction and credit information is reported to the shareholders on Schedule K-1. The S corporation must provide Schedule K-1 to each shareholder.

The corporation must report the weighted average of the shares owned by each shareholder on Schedule K-1. In most cases, these averages will correspond to the portion of each line item allocated to the shareholders.

How is a shareholder's stock basis affected by pass-through items?

Unlike a C corporation, where the basis of stock remains constant unless additional shares are purchased or sold, basis in S corporation stock will increase or decrease frequently. A shareholder's basis in the S corporation's stock is important in determining the amount of losses and deductions that can be passed through to the shareholder.

A shareholder's stock basis is increased by separately and non-separately stated items of income and gain and by additional stock purchases (and capital contributions). It is decreased by separately and non-separately stated items of loss and deduction, certain corporate distributions and nondeductible corporate expenses. Basis cannot be reduced below zero.

Example(s): Assume Lisa has an initial $10,000 basis in her S corporation stock (she owns all of the stock). If the corporation has a net operating loss of $5,000, Lisa's stock basis will be reduced to $5,000.

What taxes are unique to S corporations?

In particular, there are three additional federal taxes that might apply to an S corporation: (1) the excess net passive income tax, (2) the capital gains tax and (3) the built-in gains tax. Note, however, that if the corporation was an S corporation from its inception, it is not subject to any of these taxes. Contact your accountant, attorney or financial planning professional for information about these taxes.

How are losses treated?

Losses are passed through to the shareholders. With S corporations, pass-through losses and deductions are limited in a given year to the amount of a shareholder's actual investment in the corporation (i.e., the sum of the shareholder's stock basis and debt owed to the shareholder by the corporation).

Example(s): Rob paid $5,000 for 100% of the stock in his S corporation. In its first year of business, Rob's company lost $7,000, which was reported on the corporate income tax return and on Rob's Schedule K-1. Of this amount, Rob can claim only $5,000 as a loss, because this is the amount of his investment (basis) in the stock.

Additionally, at-risk and passive loss rules place additional limitations on an S corporation shareholder's ability to deduct losses passed through from the corporation. Contact your accountant, attorney or financial planning professional for more detailed information.

What is the qualified business income deduction?

For 2018 to 2025, an individual taxpayer can take an income tax deduction for up to 20% of the taxpayer's allocable share of domestic qualified business income from a partnership, S corporation or sole proprietorship. (The deduction may also be available for qualified REIT dividends, cooperative dividends and publicly traded partnership income.) In general, qualified business income does not include capital gains or losses, dividends, investment interest income or reasonable compensation paid to the taxpayer by the business. This deduction is not available for C corporations.

In general, the deduction for each trade or business may be subject to limits based on certain percentages of the W-2 wages and depreciable assets of the qualified business if the taxpayer's taxable income would put the taxpayer in a 32% or higher income tax bracket. (This limit does not apply to qualified REIT dividends and publicly traded partnership income.) Also, the amount of the deduction for all qualified business income cannot exceed 20% of the excess of the taxpayer's taxable income over the sum of any net capital gain of the taxpayer. For purposes of this deduction, taxable income is determined without regard for this deduction and net capital gain includes qualified dividends.