

**S corporation taxation.** An S corporation does not pay income tax at the entity level. Income, losses, deductions, and credits flow through to shareholders for reporting on their individual returns. S corporation shareholders pay tax on income at the time it is earned without regard for whether the income is withdrawn. Distributions of cash or property from an S corporation are generally not taxable up to the shareholder's adjusted basis in stock. See *Distributions*, page 19-9.

**Section 179 deduction.** In an S corporation, the Section 179 expense is not deducted from S corporation income. The amount is instead passed through to shareholders as a separately stated item. See *Separately Stated Items*, page 19-7.



## Scenario

Nate owned a lawn and garden implement store. Tyler owned a hydroseeding business. Nate and Tyler decided to go into business together under the name "Greener Pastures."

**Creating an S corporation.** Nate and Tyler consulted an attorney for advice about the choice of business entity. The attorney recommended that they operate their business as a corporation and began the process of filing the necessary documents with the Secretary of State. The attorney also assisted them in drafting an incorporation agreement. See *Incorporation Agreement*, below. Upon creation of the corporation, the official name of the company became "Greener Pastures, Inc."

- The attorney's fee was \$2,000.

**Tax advice.** The tax consultant for Greener Pastures, Inc. recommended that the corporation make the election to be taxed as an S corporation and assisted in filing the election. See *Form 2553, Election by a Small Business Corporation*, page 19-4.

The tax consultant obtained an employer identification number (EIN) for the business. See page 5-1, *1040 Edition/Deluxe Edition*, for information about obtaining an EIN. The consultant also instructed Nate and Tyler to open a business checking account and to make cash contributions to capital. The bookkeeping system was set up and procedures were put in place to provide for compensation and benefits for the shareholders.

- The tax consultant's fee was \$2,500.

## Incorporation Agreement

The incorporation agreement for Greener Pastures, Inc., contains the following provisions.

**Stock authorized.** The corporation authorized 500,000 shares of stock at par value of \$1.00 per share.

**Capital contributions.** Nate made a capital contribution in the amount of \$55,000 in exchange for 55,000 shares of stock. Tyler made a capital contribution in the amount of \$45,000 for 45,000 shares of stock. After the capital contributions, the corporation has 100,000 shares of outstanding stock.

**Note:** No gain or loss is recognized when cash is contributed to a corporation in exchange for stock.

**Shareholder wages.** The S corporation will pay wages of \$55,755 to Nate and \$44,245 to Tyler. The corporation will pay health insurance premiums and make HSA contributions for each shareholder-employee. See *Employee benefits*, next column. Total shareholder wages reported are \$60,905 (\$55,755 + \$1,800 + \$3,350) for Nate, and \$49,395 (\$44,245 + \$1,800 + \$3,350) for Tyler.



**Did You Know?** Health insurance benefits paid for more than 2% shareholders of an S corporation are taxable as wages but are not subject to FICA. The amount of the self-employed health insurance deduction should be reported in box 14 of the employee-shareholder's Form W-2. The shareholder is then able to deduct this amount as adjustments to income on Form 1040. Since the employee-shareholder's wages are increased by health benefits, that also increases the compensation for purposes of computing the employer's match for the SIMPLE plan.

In a reverse situation compared with health benefits, employee elective deferrals to a SIMPLE plan are not subject to income tax but are subject to FICA. See the instructions for Form 1120S, lines 7 and 8, page 19-18, for information about reporting these amounts.

See *Self-employed health insurance*, page 19-14, for information about health insurance policies taken out under an S corporation.

**Employee benefits.** The corporation will pay premiums of \$1,800 for each employee, which is 100% of the cost of their high-deductible medical insurance purchased through a Small Business Health Options Program (SHOP) Marketplace. It will also contribute to both HSA and SIMPLE plans for each employee.

**Health savings accounts.** The corporation will contribute \$3,350 to an HSA for each individual. See *Line 18, Employee benefit programs*, page 19-18, for how to report on Form 1120S. See also *Health Savings Accounts (HSAs)*, page 13-30, *1040 Edition/Deluxe Edition*, for more information about HSAs.

**SIMPLE plan.** The S corporation will contribute to Savings Incentive Match Plans for Employees (SIMPLE plans) by establishing SIMPLE IRAs. The corporation will match employee elective deferrals dollar-for-dollar up to 3% of each employee's wages.

**Note:** Health benefits for S corporation shareholder-employees increase taxable wages, and, therefore, increase the employer matching amount for their SIMPLE contributions. See *Savings Incentive Match Plans for Employees (SIMPLE)*, page 13-17, *1040 Edition/Deluxe Edition*.

**Employee-shareholder expenses.** Shareholders are personally responsible for paying for their own professional publications, association dues, and sanctioning fees. As corporation shareholders, these amounts will be deducted as employee business expenses on the individual tax returns, subject to the 2% of AGI limitation for employee business expenses. Compare to the same expenses in the *Partnership Example* in Tab 20, which are fully deductible and also reduce self-employment taxes.

**Did You Know?** Although an employee-shareholder can deduct employee business expenses, a shareholder of an S corporation cannot deduct expenses paid on behalf of a corporation unless a corporate resolution or policy requires payment of the expense. See *Employee Business Expense for S Corporation Shareholder*, page 19-13.

**Tax year.** The S corporation adopts a calendar tax year. The first tax year is a short tax year beginning on April 1, 2016, and ending on December 31, 2016. The corporation will establish its calendar tax year with the IRS when it files its first income tax return. See *Short Tax Year Depreciation*, page 9-5, *1040 Edition/Deluxe Edition*, and *Required Tax Year for S Corporations and PCs*, page 19-13.

**Accounting method.** The S corporation will use the cash method of accounting.

**Note:** The S corporation will hold inventory consisting of lawn and garden implements and hydroseeding materials. Under the general rule, if a company carries inventory, the accrual method of accounting must be used for purchases and sales. However, businesses with average gross receipts of \$1 million or less are eligible to use the cash method of accounting. Even though Greener Pastures, Inc. will use the cash method of accounting,

*continued on page 19-17*

## Payroll Report for Year Ended December 31, 2016

Employee	Gross Earnings	Social Security 6.20%	Medicare 1.45%	Federal Withholding	State Withholding	Health Insurance & HSA Contributions	SIMPLE Elective Deferrals	Net Pay
Nate	\$ 60,905.00	\$ 3,456.81	\$ 808.45	\$ 9,204.00	\$ 3,336.00	\$ 5,150.00	\$ 5,500.00	\$ 33,449.74
Tyler	\$ 49,395.00	\$ 2,743.19	\$ 641.55	\$ 6,324.00	\$ 1,924.00	\$ 5,150.00	\$ 4,500.00	\$ 28,112.26
Evan	\$ 31,200.00	\$ 1,934.40	\$ 452.40	\$ 3,912.00	\$ 1,632.00		\$ 3,120.00	\$ 20,149.20
Cyndi	\$ 26,000.00	\$ 1,612.00	\$ 377.00	\$ 3,120.00	\$ 1,272.00		\$ 2,600.00	\$ 17,019.00
Tristan	\$ 20,800.00	\$ 1,289.60	\$ 301.60	\$ 2,328.00	\$ 996.00		\$ 2,080.00	\$ 13,804.80
Jordan	\$ 20,800.00	\$ 1,289.60	\$ 301.60	\$ 2,328.00	\$ 996.00		\$ 2,080.00	\$ 13,804.80
Totals	\$209,100.00	\$12,325.60	\$2,882.60	\$27,216.00	\$10,156.00	\$10,300.00	\$19,880.00	\$126,339.80

### Final Pay Period—Taxes Deposited January 2017

	Gross Earnings	Social Security 6.20%	Medicare 1.45%	Federal Withholding	State Withholding	Health Insurance HSA Contributions	SIMPLE Elective Deferrals	Net Pay
	\$ 3,823.08	\$ 237.03	\$ 55.43	\$ 523.38	\$ 195.31		\$ 382.31	\$ 2,429.62

## 2016 Depreciation Schedule—Greener Pastures, Inc.

Asset	Placed in Service	Basis	Section 179	Depreciable Basis	Recovery Period	Method
Equipment	April 1, 2016	\$23,600.00	\$23,600.00	\$ 0.00	7 yr.	200DB
Display shelving	April 1, 2016	\$ 8,950.00	\$ 0.00	\$ 8,950.00	7 yr.	200DB
Office furniture	April 1, 2016	\$ 3,675.00	\$ 0.00	\$ 3,675.00	7 yr.	200DB
Computers	April 1, 2016	\$ 3,890.00	\$ 0.00	\$ 3,890.00	5 yr.	200DB
Totals		\$40,115.00	\$23,600.00	\$16,515.00		

### Regular Tax Depreciation—Short Tax Year 200DB

Display shelving	$\$8,950 \times \frac{1}{7} \times 200\% \times \frac{4.5}{12} = \$ 959$
Office furniture	$\$3,675 \times \frac{1}{7} \times 200\% \times \frac{4.5}{12} = \$ 394$
Computers	$\$3,890 \times \frac{1}{5} \times 200\% \times \frac{4.5}{12} = \$ 584$
Total regular tax depreciation	\$1,937

**AMT—Short Tax Year 150DB.** Refigure depreciation for AMT purposes for property depreciated using the 200% DB method by using the 150% DB method with the same convention and recovery period. Costs recovered under Section 179 do not need to be added back for AMT.

Display shelving	$\$8,950 \times \frac{1}{7} \times 150\% \times \frac{4.5}{12} = \$ 719$
Office furniture	$\$3,675 \times \frac{1}{7} \times 150\% \times \frac{4.5}{12} = \$ 295$
Computers	$\$3,890 \times \frac{1}{5} \times 150\% \times \frac{4.5}{12} = \$ 438$
Total AMT depreciation	\$1,452

**AMT depreciation adjustment:** \$1,937 – \$1,452 = \$485

## Balance Sheet—Greener Pastures, Inc.

December 31, 2016

<b>Assets:</b>	
Cash	\$142,117.29
Inventory	9,100.00
Equipment	23,600.00
Display shelving	8,950.00
Office furniture	3,675.00
Computers	3,890.00
Accumulated depreciation	(25,537.00)
Total assets	\$165,795.29
<b>Liabilities:</b>	
Withholding payable	\$ 1,011.16
SIMPLE employee deferrals payable	382.31
Sales tax payable	1,234.64
Loan payable	20,459.27
Total liabilities	\$ 23,087.38
<b>Equity:</b>	
Common stock	\$100,000.00
Current earnings	52,707.91
Distributions	(10,000.00)
Total equity	\$142,707.91
Total liabilities plus equity	\$165,795.29

## Income Statement—Greener Pastures, Inc.

Year ended December 31, 2016

### Revenue:

Lawn and garden implement sales	\$215,500.00
Hydroseeding services	212,450.00
Interest earned	566.00
Gross income	\$428,516.00

### Cost of goods sold:

Beginning inventory	\$ 0.00
Purchases	74,025.00
Ending inventory	(9,100.00)
Cost of goods sold	\$ 64,925.00
Gross profit	\$363,591.00

### Expenses:

Accounting (organization costs)	\$ 2,500.00
Advertising	3,000.00
Attorney fees (organization costs)	2,000.00
Bookkeeping	2,800.00
Depreciation	25,537.00
Employee benefit programs	
HSA contributions	13,400.00
Health insurance	7,200.00
SIMPLE employer match	6,273.00
Insurance—business	3,250.00
Interest expense	916.36
Meals and entertainment	1,100.00
Office expenses	2,325.00
Payroll taxes	17,971.73
Rent	9,000.00
Travel (start-up costs)	1,660.00
Utilities	2,850.00
Wages (includes <del>\$6,600</del> for shareholder <b>\$6,700</b> )	
HSA contributions and <del>\$9,000</del> for health insurance) <b>\$3,600</b>	209,100.00
Total expenses	\$310,883.09
Net income per books	\$ 52,707.91