

1991



Department of the Treasury
Internal Revenue Service

Instructions for Schedule D (Form 1120S)

Capital Gains and Losses and Built-In Gains

(Section references are to the Internal Revenue Code unless otherwise noted.)

Purpose of Schedule

Schedule D is used by all S corporations to report (a) sales or exchanges of capital assets, and (b) gains on distributions to shareholders of appreciated assets that are capital assets (hereinafter referred to as distributions). See definition of capital assets below.

If the corporation filed its election to be an S corporation before 1987 (or filed its election during 1987 or 1988 and qualifies for the transitional relief from the built-in gains tax described in Part IV below), and had net capital gain (line 9) of more than \$25,000, it may be liable for a capital gains tax on the gain in excess of \$25,000. The tax is figured in Part III of Schedule D.

Generally, if the corporation (a) filed an election to be an S corporation after 1986, (b) was a C corporation at the time it made the election, and (c) has net recognized built-in gain as defined in section 1374(d)(2), it is liable for the built-in gains tax. The tax is figured in Part IV of Schedule D.

Sales, exchanges, and distributions of property other than capital assets, including property used in a trade or business, involuntary conversions (other than casualties or thefts), and gain from the disposition of an interest in oil, gas, or geothermal property should be reported on Form 4797, Sales of Business Property.

If property is involuntarily converted because of a casualty or theft, use Form 4684, Casualties and Thefts.

Parts I and II

Generally, report sales or exchanges (including like-kind exchanges) even if there is no gain or loss. In Part I, report the sale, exchange, or distribution of capital assets held 1 year or less. In Part II, report the sale, exchange, or distribution of capital assets held more than 1 year. Use the trade dates for the dates of acquisition and sale of stocks and bonds on an exchange or over-the-counter market.

What Are Capital Assets?— Each item of property the corporation held (whether or not connected with its trade or business) is a capital asset **except:**

1. Assets that can be inventoried or property held mainly 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 memorandums; or similar property.
4. Accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in 1 above.
5. U.S. Government publications, including the Congressional Record, that the corporation received from the Government, other than by purchase at the normal sales price, or that the corporation got from another taxpayer who had received it in a similar way, if the corporation's basis is determined by reference to the previous owner.

Exchange of "Like-Kind" Property.— Use Form 8824, Like-Kind Exchanges, to report an exchange of like-kind property. Also report the exchange on Schedule D or on Form 4797, whichever applies. Complete and attach a Form 8824 to the corporation's return for each exchange. The corporation must report an exchange of business or investment property for "like-kind" property even if no gain or loss on the property is recognized.

If Schedule D is used to report a like-kind exchange, write "From Form 8824" on the appropriate line (line 1 or 4, column (a)). Skip columns (b) through (e) and enter the gain or loss, if any, from Form 8824 in column (f). If an exchange was made with a related party, write "Related Party Like-Kind Exchange" in the top margin of Schedule D. See Form 8824 and its instructions for details.

Special Rules for the Treatment of Certain Gains and Losses

Note: For more information, get **Pub. 544, Sales and Other Dispositions of Assets**, and **Pub. 589, Tax Information on S Corporations**.

• **Loss from a sale or exchange between the corporation and a related person.**—Except for distributions in complete liquidation of a corporation, no

loss is allowed from the sale or exchange of property between the corporation and certain related persons. See section 267 for details.

• **Loss from a wash sale.**—The corporation cannot deduct a loss from a wash sale of stock or securities (including contracts or options to acquire or sell stock or securities) unless the corporation is a dealer in stock or securities and the loss was sustained in a transaction made in the ordinary course of the corporation's trade or business. A wash sale occurs if the corporation acquires (by purchase or exchange), or has a contract or option to acquire, substantially identical stock or securities within 30 days before or after the date of the sale or exchange. See section 1091 for more information.

• **Gain on distribution of appreciated property.**—Generally, gain (but not loss) is recognized on a nonliquidating distribution of appreciated property to the extent that the property's fair market value exceeds its adjusted basis. See section 311 for more information.

• **Gain or loss on distribution of property in complete liquidation.**—Generally, gain or loss is recognized by a corporation upon the liquidating distribution of property as if it had sold the property at its fair market value. See section 336 for details and exceptions.

• **Gains and losses on section 1256 contracts and straddles.**—Use Form 6781, Gains and Losses From Section 1256 Contracts and Straddles, to report gains and losses from section 1256 contracts and straddles.

• **Gain or loss on certain short-term Federal, state, and municipal obligations.**—Such obligations are treated as capital assets in determining gain or loss. On any gain realized, a portion is treated as ordinary income and the balance is considered as a short-term capital gain. See section 1271.

• **Gain from installment sales.**—If a corporation has a gain this year from the sale of real property or a casual sale of personal property other than inventory and is to receive any payment in a later year, it must use the installment method (unless it elects not to) and file Form 6252, Installment Sale Income. Also use

Form 6252 if a payment is received this year from a sale made in an earlier year on the installment basis.

The corporation may elect out of the installment method by doing the following on a timely filed return (including extensions):

- 1. Report the full amount of the sale on Schedule D.
- 2. If the corporation received a note or other obligation and is reporting it at less than face value (including all contingent obligations), state that fact in the margin and give the percentage of valuation.

The installment method may not be used for sales of stock or securities (or certain other property described in the regulations) traded on an established securities market. See section 453(k).

- **Gain or loss on an option to buy or sell property.**—See sections 1032 and 1234 for the rules that apply to a purchaser or grantor of an option.
- **Gain or loss from a short sale of property.**—Report the gain or loss to the extent that the property used to close the short sale is considered a capital asset in the hands of the taxpayer.
- **Loss from securities that are capital assets that become worthless during the year.**—Except for securities held by a bank, treat the loss as a capital loss as of the last day of the tax year. (See section 582 for the rules on the treatment of securities held by a bank.)
- **Nonrecognition of gain on sale of stock to an ESOP.**—See section 1042 for rules under which a taxpayer may elect not to recognize gain from the sale of certain stock to an employee stock ownership plan (ESOP).
- **Disposition of market discount bonds.**—See section 1276 for rules on the disposition of any market discount bonds that were issued after July 18, 1984.
- **Capital gain distributions.**—Report capital gain distributions paid by mutual funds as long-term capital gain on line 4 regardless of how long the corporation owned stock in the fund.

How To Determine the Cost or Other Basis of the Property

In determining gain or loss, the basis of property will generally be its cost (see section 1012 and related regulations). The exceptions to the general rule are provided in sections contained in subchapters C, K, O, and P of the Code. For example, if the corporation acquired the property by dividend, liquidation of another corporation, transfer from a shareholder, reorganization, bequest, contribution or gift, tax-free exchange, involuntary conversion, certain asset acquisitions, or wash sale of stock, see sections 301 (or 1059), 334, 362 (or 358), 1014, 1015, 1031, 1033, 1060, and 1091, respectively. Attach an explanation

if you use a basis other than actual cash cost of the property.

If the corporation is allowed a charitable contribution deduction because it sold property to a charitable organization, figure the adjusted basis for determining gain from the sale by dividing the amount realized by the fair market value and multiplying that result by the adjusted basis.

See section 852(f) for the treatment of certain load charges incurred in acquiring stock in a mutual fund with a reinvestment right.

Part III—Capital Gains Tax

If the net long-term capital gain is more than the net short-term capital loss, there is a net capital gain. If this gain exceeds \$25,000, and the corporation elected to be an S corporation before 1987 (or filed its election during 1987 or 1988 and qualifies for the transitional relief from the built-in gains tax described in Part IV below), the corporation may be liable for income tax on the gain.

By answering the following questions, it can be determined whether the corporation is liable for the tax. If answers to questions A, B, and C or A, B, and D are "Yes," the tax applies and Part III of Schedule D must be completed. Otherwise, the corporation is not liable for the tax.

If net capital gain is more than \$25,000, and the corporation is not liable for the tax, attach the Part III instructions to Schedule D with questions A through D answered to show why the tax does not apply.

- A. Is net capital gain (line 9, Schedule D) more than \$25,000, and more than 50% of taxable income (see the instructions for line 13, Schedule D)? Yes No
- B. Is taxable income (see the instructions for line 13, Schedule D) more than \$25,000? Yes No
- C. Has the corporation been other than an S corporation at any time during the 3 tax years just before this year, or since existence, if it has been in existence for less than 4 years? Yes No
- D. If the answer to question C is "No," does any long-term capital gain (line 8, Schedule D) represent gain from property described in each of items 1, 2, and 3 that follow? Yes No

- 1. The property was acquired during the tax year or within 36 months before the beginning of the tax year;
- 2. The property was acquired, directly or indirectly, from a corporation that was not in existence as an S corporation during the tax year or within 36 months before the tax year up to the time of the acquisition; and
- 3. The property has a substituted basis to you. (A substituted basis is determined by reference to its basis in the hands of the transferor corporation.)

If the answer to question D is "Yes" and the tax applies, multiply the net capital gain from property described in question D (reduced by any excess net passive income attributable to this gain—see instruction for line 9) by 34%. If this amount is less than the tax figured on line 14, Part III, enter this amount on line 15, Part III, and write to the right of the amount, "Substituted basis." Attach the computation of the substituted basis amount to Schedule D. (See section 1374(c)(3) as in effect before the enactment of the Tax Reform Act of 1986 (1986 Act).)

Line 9.—If the corporation is liable for the tax on excess net passive income (line 22a, page 1, Form 1120S) or the built-in gains tax (see Part IV below), and capital gain or loss was included in the computation of either tax, figure the amount to enter on line 9 as follows:

Step 1—Refigure lines 1, 2, and 4 through 7 of Schedule D by:

- 1. Excluding the portion of any recognized built-in capital gain or loss that does not qualify for transitional relief, and
- 2. Reducing any capital gain taken into account in determining passive investment income (line 2 of the worksheet for line 22a, page 1 of Form 1120S) by the portion of excess net passive income attributable to such gain. The portion so attributable is figured by multiplying excess net passive income by a fraction, the numerator of which is the amount of the capital gain (less any expenses attributable to such gain), and the denominator of which is net passive income.

Step 2—Refigure lines 3, 8, and 9 of Schedule D using the amounts determined in step 1.

Line 13.—Figure taxable income by completing lines 1 through 28 of **Form 1120, U.S. Corporation Income Tax Return**. Enter the amount from line 28 of Form 1120 on line 13 of Schedule D. Attach to Schedule D the Form 1120 computation or other worksheet used to figure taxable income.

Line 14.—Figure the tax under section 11 on the taxable income shown on line 13 as if the corporation were not an S corporation. You may use Schedule J of Form 1120 to figure the tax. Attach your tax computation to Schedule D.

Part IV—Built-In Gains Tax

Section 1374 provides for a tax on built-in gains that applies to certain corporations that made the election to be an S corporation after 1986. This tax does not apply to any corporation that has been an S corporation for each of its tax years, unless the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation.

Transitional Relief From Built-In Gains Tax.—Section 633(d)(8) of the 1986 Act provides special transitional relief from the built-in gains tax for qualified corporations. A qualified corporation is any corporation that **(a)** on August 1, 1986, and all times thereafter before the corporation is completely liquidated, is more than 50% owned by a qualified group, and **(b)** has an applicable value of \$10 million or less.

A qualified group is a group of 10 or fewer qualified persons. A qualified person is:

1. An individual,
2. An estate, or
3. A trust described in section 1361(c)(2)(A)(ii) or (iii).

The qualified group must have owned (or be treated as having owned) more than 50% (by value) of the corporation's stock at all times during the 5-year period ending on the date of adoption of a plan of complete liquidation (or, if shorter, the period of the corporation's existence). The 5-year requirement does not apply to any corporation that made an S election before March 31, 1988. The term "applicable value" means the fair market value of all of the stock of the corporation on the date a valid S election is made (or, if greater, on August 1, 1986).

The transitional relief rule applies to qualified corporations that elected to be S corporations during 1987 or 1988. However, the relief rule does **not** apply to the following items:

1. Ordinary gains or losses (determined without regard to section 1239),
2. Gains or losses from the disposition of capital assets held 6 months or less, and
3. Gains from the disposition of any asset acquired by the corporation with a substituted basis if a principal purpose for acquiring the asset was to secure transitional relief from the built-in gains tax.

Qualified corporations with an applicable value of between \$5 million and \$10 million are given only partial relief from the built-in gains tax. The portion of the built-in gain **not** eligible for relief is a fraction, the numerator of

which is the amount by which the applicable value of the corporation exceeds \$5 million and the denominator of which is \$5 million.

Line 16.—Enter the amount that would be the taxable income of the corporation for the tax year if only recognized built-in gains (including any carryover of gain under section 1374(d)(2)(B)) and recognized built-in losses were taken into account.

Section 1374(d)(3) defines a **recognized built-in gain** as any gain recognized during the recognition period (the 10-year period beginning on the 1st day of the 1st tax year for which the corporation is an S corporation, or beginning the date the asset was acquired by the S corporation, for an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation) on the sale or distribution (disposition) of any asset, except to the extent the corporation establishes that:

1. The asset was not held by the corporation as of the beginning of the 1st tax year the corporation was an S corporation (except that this does not apply to an asset acquired by the S corporation with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation), or
2. The gain exceeds the excess of the fair market value of such asset as of the beginning of the 1st tax year (or as of the date the asset was acquired by the S corporation, for an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation) over the adjusted basis of the asset at that time.

Section 1374(d)(4) defines a **recognized built-in loss** as any loss recognized during the recognition period (stated above) on the disposition of any asset to the extent the corporation establishes that:

1. The asset was held by the corporation as of the beginning of the 1st tax year the corporation was an S corporation (except that this does not apply to an asset acquired by the S corporation with a basis determined by reference to its basis (or the basis of any

other property) in the hands of a C corporation), and

2. The loss does not exceed the excess of the adjusted basis of the asset as of the beginning of the 1st tax year (or as of the date the asset was acquired by the S corporation, for an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation), over the fair market value of the asset as of that time.

A qualified corporation must show on an attachment to Schedule D its total net recognized built-in gain and also list separately the gain or loss that is **(a)** gain or loss from capital assets held 6 months or less, and **(b)** gain or loss from assets for which the disposition results in ordinary income or loss. A nonqualified corporation must show on an attachment its total net recognized built-in gain and list separately any capital gain or loss and ordinary gain or loss.

Line 17.—Figure taxable income by completing lines 1 through 28 of Form 1120. Enter the amount from line 28 of Form 1120 on line 17. Attach to Schedule D the Form 1120 computation or other worksheet used to figure taxable income.

Line 18.—Do not enter on line 18 more than the excess (if any) of the net unrealized built-in gain over the net recognized built-in gain for prior years. This is the amount that should have been entered on line 9 of Schedule B on page 2 of Form 1120S. See section 1374(c)(2). If, for any tax year, the amount on line 16 exceeds the taxable income on line 17, the excess is treated as a recognized built-in gain in the succeeding tax year. This carryover provision applies only in the case of an S corporation that made its election to be an S corporation on or after March 31, 1988. See section 1374(d)(2)(B).

Line 19.—Enter the section 1374(b)(2) deduction. Generally, this is any net operating loss carryforward or capital loss carryforward (to the extent of net capital gain included in recognized built-in gain for the tax year) arising in tax years for which the corporation was a C corporation. See section 1374(b)(2) for details.