



# 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.

### General Instructions

#### Purpose of Schedule

Schedule D is used by all S corporations to report:

- Sales or exchanges of capital assets.
- Gains on distributions to shareholders of appreciated capital assets (referred to here as distributions).
- Nonbusiness bad debts.

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 on page 3), and had net capital gain (line 16) 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 filed an election to be an S corporation after 1986, was a C corporation at the time it made the election, **and** 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.

#### Other Forms The Corporation May Have To File

Use **Form 4797**, Sales of Business Property, to report:

- Sales, exchanges, and distributions of property other than capital assets, including property used in a trade or business.
- Involuntary conversions (other than from casualties or thefts).

Use **Form 4684**, Casualties and Thefts, to report involuntary conversions of property due to casualty or theft.

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

Use **Form 8824**, Like-Kind Exchanges, if the corporation made one or more like-kind exchange. A "like-kind

exchange" occurs when business or investment property is exchanged for property of a like kind. For exchanges of capital assets, enter the gain or loss from Form 8824, if any, on line 3 or line 9 in column (f), and in column (g) if required.

#### Capital Asset

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

- Stock in trade or other property included in inventory or held mainly for sale to customers.
- Accounts or notes receivable acquired in the ordinary course of the trade or business for services rendered or from the sale of stock in trade or other property held mainly for sale to customers.
- Depreciable or real property used in the trade or business.
- Certain copyrights; literary, musical, or artistic compositions; letters or memorandums; or similar property. See section 1221(3).
- 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.

#### Items for Special Treatment

**Note:** For more information, see **Pub. 544**, *Sales and Other Dispositions of Assets*.

**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 details.

**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.

**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 reported in an earlier year on the installment basis.

The corporation may **elect out** of the installment method by reporting the full amount of the gain on a timely filed return (including extensions). See Regulations section 301.9100-2 to make the election on an amended return within 6 months of the due date (excluding extensions).

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 employee stock ownership plan (ESOP) or an eligible cooperative.** See section 1042 and Temporary Regulations section 1.1042-1T for rules under which a taxpayer may elect not to recognize gain from the sale of certain stock to an ESOP or an eligible cooperative.

**Disposition of market discount bonds.** See section 1276 for rules on the disposition of any market discount bonds.

**Capital gain distributions.** Report the total capital gain distributions as long-term capital gain on line 7, column (f), regardless of how long the corporation held the investment. Enter on line 7, column (g), the total amounts reported as the 28% rate gain portion of your total capital gain distributions.

**Nonbusiness bad debts.** A nonbusiness bad debt must be treated as a short-term capital loss and can be deducted only in the year the debt becomes totally worthless. For each bad debt, enter the name of the debtor and "schedule attached" in column (a) of line 1 and the amount of the bad debt as a loss in column (f). Also attach a statement of facts to support each bad debt deduction.

**Real estate subdivided for sale.** Certain lots or parcels that are part of a tract of real estate subdivided for sale may be treated as capital assets. See section 1237.

**Sale of a partnership interest.** A sale or other disposition of an interest in a partnership owning unrealized receivables or inventory items may result in ordinary gain or loss. See **Pub. 541**, Partnerships, for more details.

**Constructive sales treatment for certain appreciated positions.** Generally, the corporation must recognize gain (but not loss) on the date it enters into a constructive sale of any appreciated interest in stock, a partnership interest, or certain debt instruments as if the position were disposed of at fair market value on that date.

The corporation is treated as making a constructive sale of an appreciated position if it (or a related person, in some cases) does **one** of the following:

- Enters into a short sale of the same or substantially identical property (i.e., a "short sale against the box").
- Enters into an offsetting notional principal contract relating to the same or substantially identical property.
- Enters into a futures or forward contract to deliver the same or substantially identical property.
- Acquires the same or substantially identical property (if the appreciated position is a short sale, offsetting notional principal contract, or a futures or forward contract).

**Exception.** Generally, constructive sales treatment **does not** apply if:

- The transaction was closed before the end of the 30th day after the end of the year in which it was entered into,
- The appreciated position to which the transaction relates was held throughout the 60-day period starting on the date the transaction was closed, **and**
- At no time during that 60-day period was the corporation's risk of loss reduced by holding certain other positions.

For details and other exceptions to these rules, see **Pub. 550**, Investment Income and Expenses.

**Rollover of gain from qualified stock.** If the corporation sold qualified small business stock (defined below) that it held for more than 6 months, it may postpone gain if it purchased other qualified small business stock during the 60-day period that began on the date of the sale. The corporation must recognize gain to the extent the sale proceeds exceed the cost of the replacement stock. Reduce the basis of the replacement stock by any postponed gain.

If the corporation chooses to postpone gain, report the entire gain realized on the sale on line 1 or 7. Directly below the line on which the corporation reported the gain, enter in column (a) "Section 1045 Rollover" and enter as a (loss) in column (f) the amount of the postponed gain.



*The corporation also must separately state the amount of the gain rolled over on qualified stock under section 1045 on Form 1120S, Schedule K, line 6, because each shareholder must determine if he or she qualifies for the rollover at the shareholder level. Also, the corporation must include on Schedule D, line 1 or 7 (and on Form 1120S, Schedule K, line 6), any gain that could qualify for the section 1045 rollover at the shareholder level instead of the corporate level (because a shareholder was entitled to purchase replacement stock). If the corporation had a gain on qualified stock that could qualify for the 50% exclusion under section 1202, report that gain on Schedule D, line 7 (and on Form 1120S, Schedule K, line 6).*

To be **qualified small business stock**, the stock must meet **all** of the following tests:

- It must be stock in a C corporation.
- It must have been originally issued after August 10, 1993.
- As of the date the stock was issued, the C corporation was a qualified small business. A qualified small business is a domestic C corporation with total gross assets of \$50 million or less (**a**) at all times after August 9, 1993, and before the stock was issued, and (**b**) immediately after the stock was issued. Gross assets include those of any predecessor of the corporation. All corporations that are members of the same parent-subsidiary controlled group are treated as one corporation.
- The corporation must have acquired the stock at its original issue (either directly or through an underwriter), either in exchange for money or other property or as pay for services (other than as an underwriter) to the corporation. In certain cases, the corporation may meet the test if it acquired the stock from another person who met this test (such as by gift or inheritance) or through a conversion or exchange of qualified small business stock held by the corporation.
- During substantially all the time the corporation held the stock:

1. The issuer was a C corporation,
2. At least 80% of the value of the issuer's assets were used in the active conduct of one or more qualified businesses (defined below), and
3. The issuing corporation **was not** a foreign corporation, DISC, former DISC, corporation that has made (or that has a subsidiary that has made) a section 936 election, regulated investment company, real estate investment trust, REMIC, FASIT, or cooperative.

**Note:** A *specialized small business investment company (SSBIC)* is treated as having met test 2 above.

A **qualified business** is any business **other than** the following:

- One involving services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services.
- One whose principal asset is the reputation or skill of one or more employees.
- Any banking, insurance, financing, leasing, investing, or similar business.
- Any farming business (including the raising or harvesting of trees).
- Any business involving the production of products for which percentage depletion can be claimed.
- Any business of operating a hotel, motel, restaurant, or similar business.

# Specific Instructions

## 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 traded on an exchange or over-the-counter market.

**Column (e)—Cost or other basis.** In determining gain or loss, the basis of property is generally its cost (see section 1012 and related regulations). Special rules for determining basis are provided in sections in subchapters C, K, O, and P of the Code. These rules may apply to the corporation on the receipt of certain distributions with respect to stock (section 301), liquidation of another corporation (334), transfer to another corporation (358), transfer from a shareholder or reorganization (362), bequest (1014), contribution or gift (1015), tax-free exchange (1031), involuntary conversion (1033), certain asset acquisitions (1060), or wash sale of stock (1091). 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.

Before making an entry in column (e), increase the cost or other basis by any expense of sale, such as broker's fees, commissions, option premiums, and state and local transfer taxes, unless the net sales price was reported in column (d).

**Column (f)—Gain or (loss).** Make a separate entry in this column for each transaction reported on lines 1 and 7 and any other line(s) that apply to the corporation. For lines 1 and 7, subtract the amount in column (e) from the amount in column (d). Enter negative amounts in parentheses.

**Column (g)—28% rate gain or (loss).** Enter the amount, if any, from Part II, column (f), that is from collectibles gains and losses. A **collectibles gain or loss** is any long-term gain or loss from the sale or exchange of a collectible that is a capital asset.

**Collectibles** include works of art, rugs, antiques, metals (such as gold, silver, and platinum bullion), gems, stamps, coins, alcoholic beverages, and certain other tangible property.

Also include gain from the sale of an interest in a partnership or trust attributable to unrealized appreciation of collectibles.

## 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.

Determine if the corporation is liable for the tax by answering questions A, B, and C below. If all the answers 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, B, and C answered to show why the tax does not apply.

- A. Is net capital gain (line 16, Schedule D) more than \$25,000, and more than 50% of taxable income (see the instructions for line 20, Schedule D)? . . . . .  Yes  No
- B. Is taxable income (see the instructions for line 20, Schedule D) more than \$25,000? . . . . .  Yes  No
- C. Does any long-term capital gain (line 15, Schedule D) represent gain from substituted basis property (defined below)? . . . . .  Yes  No

For purposes of the capital gains tax, **substituted basis property** is property that:

- Was acquired by the S corporation during the period that began 36 months before the first day of the tax year and ended on the last day of the tax year, and
- Has a basis determined by reference to the basis of any property in the hands of another corporation, if the other corporation was **not** an S corporation throughout the period that, **began** the later of:
  1. 36 months before the first day of the tax year, or
  2. The time the other corporation came into existence,and **ended** on the date the other corporation transferred the property used to determine the basis of the property acquired by the S corporation.

**Line 16.** 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 16 as follows:

**Step 1.** Refigure lines 1 through 3, 7 through 9 in column (f), and 14 of Schedule D by:

- Excluding the portion of any recognized built-in capital gain or loss that does not qualify for transitional relief, and
- 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 attributable portion is figured by multiplying excess net passive income by a fraction, the numerator of which is the capital gain (less any expenses attributable to such gain), and the denominator of which is net passive income.

**Step 2.** Refigure lines 4, 10, 15, and 16 of Schedule D using the amounts determined in step 1.

**Line 20.** Figure taxable income by completing lines 1 through 28 of **Form 1120**, U.S. Corporation Income Tax Return. Follow the instructions for Form 1120. Enter the amount from line 28 of Form 1120 on line 20 of Schedule D. Attach to Schedule D the Form 1120 computation or other worksheet used to figure taxable income.

**Line 21.** Figure the tax under section 11 on the taxable income shown on line 20 as if the corporation were not an S corporation. You may use Schedule J of Form 1120 to figure the tax. Attach the tax computation to Schedule D.

**Line 22.** Figure the excess of the net long-term capital gain over the net short-term capital loss from substituted basis property (defined above). Reduce this amount by any excess net passive income attributable to this gain (see the instructions for line 16). Attach to Schedule D your computation of the line 22 amount.

## 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 Tax Reform Act of 1986 provides special transitional relief from the built-in gains tax for

qualified corporations that elected to be S corporations during 1987 or 1988. A qualified corporation is any corporation, the stock of which:

- Was more than 50% owned (by value) by a qualified group (defined below) on August 1, 1986, and at all times thereafter before the corporation is completely liquidated, and
- Had a fair market value of less than \$10 million on both the date the corporation made a valid S election and on August 1, 1986. However, if the fair market value of the stock on either date was between \$5 million and \$10 million, the corporation is 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 fair market value of the corporation on the date it made a valid S election (or on August 1, 1986, if higher) exceeds \$5 million and the denominator of which is \$5 million.

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

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

For any corporation that elected to be an S corporation after March 30, 1988, 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.

Transitional relief **does not** apply to:

- Ordinary gains or losses (determined without regard to section 1239),
- Gains or losses from the disposition of capital assets held for 6 months or less, and
- 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.

**Line 25.** 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 first day of the first 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—

- The asset was not held by the corporation as of the beginning of the first tax year the corporation was an S corporation (except 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
- The gain exceeds the excess of the fair market value of the asset as of the start of the first 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—

- The asset was held by the corporation as of the beginning of the first 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

- The loss does not exceed the excess of the adjusted basis of the asset as of the beginning of the first 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 from:

- Capital assets held 6 months or less, and
- 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 26.** Figure taxable income by completing lines 1 through 28 of Form 1120. Follow the instructions for Form 1120. Enter the amount from line 28 of Form 1120 on line 26 of Schedule D. Attach to Schedule D the Form 1120 computation or other worksheet used to figure taxable income.

**Line 27.** If for any tax year the amount on line 25 exceeds the taxable income on line 26, 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 after March 30, 1988. See section 1374(d)(2)(B).

**Line 28.** 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.