

Carter Tax Detective Glossary and Knowledge Test

A working reference for reading Carter Medical Technologies LLC tax records. The definitions focus on an S corporation and its shareholder. The test checks whether the reader can follow income, basis, deductions, and cash through the returns. Rules and form requirements depend on the tax year and facts.

Entity and income

Flow through entity. A business whose tax items generally pass to owners for reporting on their returns. An S corporation ordinarily reports its income on Form 1120-S and allocates items to shareholders on Schedule K-1, even if it distributes no cash.

S corporation. A corporation, or eligible entity electing corporate status, with a valid S election. Its federal income generally passes through to shareholders, subject to exceptions such as certain entity-level taxes.

Ordinary business income. Net income from regular operations reported by the S corporation and allocated to shareholders. It is distinct from wages, cash distributions, and gross receipts.

Gross receipts and net income. Gross receipts are revenue before business deductions. Net income reflects allowable deductions and other tax adjustments; neither figure by itself establishes owner cash flow.

Reasonable compensation. Wages an S corporation pays a shareholder-employee for services, subject to payroll tax and reported on Form W-2. A distribution cannot simply replace wages for services.

Distribution. Cash or property paid to a shareholder in that capacity. It is not a wage or corporate expense; its tax treatment depends in part on stock basis and corporate earnings history.

Shareholder loan. A bona fide debt between a shareholder and corporation. A repayment of principal differs from compensation or a distribution; loan documents and actual cash movement matter.

Basis and deductions

Tax basis. An owner's tax investment in property or an interest, adjusted under tax rules. Basis helps determine gain or loss and whether some losses or distributions are taxable.

Stock basis. A shareholder's adjusted basis in S corporation stock. It generally rises with contributions and allocated income and falls with distributions and losses, subject to ordering rules.

Debt basis. Basis in qualifying indebtedness of the S corporation directly to the shareholder. It may support loss deductions after stock basis is exhausted; a bank loan guaranteed by the shareholder alone ordinarily does not create debt basis.

Adjusted basis. Original basis changed by applicable additions and reductions, such as improvements, depreciation, contributions, income, distributions, and allowed losses, depending on the asset.

Depreciation. A tax deduction that recovers the cost or other basis of eligible business property over prescribed periods. It can reduce taxable income without a matching current-year cash payment.

Section 179 deduction. An election to expense qualifying property, within statutory limits and other restrictions, rather than recover its cost solely over the normal depreciation period.

Bonus depreciation. An additional first-year depreciation allowance for eligible property under the rules applicable when it is placed in service; rates and eligibility can change by year.

Placed in service. The point when property is ready and available for its intended business use, generally relevant to when depreciation begins.

Loss limitation. Rules that can defer an owner's deduction for a pass-through loss, including basis, at-risk, passive activity, and other applicable limitations. A K-1 loss is not automatically deductible.

Cash flow versus taxable income. Cash received or available and taxable income measure different things. Noncash depreciation, unpaid pass-through income, borrowing, loan repayment, and distributions can cause large differences.

Important forms and records

Form 1120-S. The S corporation's federal income tax return. Review its income, deductions, balance sheet when included, and supporting schedules.

Schedule K-1 Form 1120-S. The corporation's statement of each shareholder's allocated tax items. It reports the share of income, deductions, credits, and basis-related items, not necessarily cash paid.

Form 1040. The individual federal income tax return. Compare the shareholder's reporting with wages, K-1 items, and other sources.

Schedule E Form 1040. The individual schedule generally used to report pass-through S corporation income or loss and certain other supplemental income.

Form W-2. The annual wage statement reporting compensation and withholding; useful for separating salary from S corporation distributions.

Form 7203. The shareholder's computation of S corporation stock and debt basis and the related basis limitation; filing is required in specified circumstances.

Form 4562. The form for depreciation and amortization, including Section 179 elections, when required. Review it with the asset ledger and acquisition records.

Form 4797. The form generally used to report sales or other dispositions of business property and certain related gains or losses.

Form 1099 and bank records. Information returns may identify payments, but bank statements, general ledger detail, payroll, and loan records help test whether reported items match actual transactions.

Schedule L and Schedule M-2. When required, Form 1120-S schedules showing book balance-sheet information and accumulated adjustments account or other equity-related tax accounts. Book equity is not shareholder stock basis.

Knowledge Test

Choose the best answer. Carter figures are hypothetical and simplified. Each question is worth one point.

1. Carter reports \$200,000 of ordinary income allocated to its sole shareholder but pays no distribution. Which statement is generally correct?

- A. The income vanishes until cash is paid
- B. The shareholder generally reports the allocated income
- C. The amount is automatically a wage
- D. The amount is a shareholder loan

2. Which document reports the shareholder's allocated share of S corporation tax items?
- A. Form W-2
 - B. Form 4562
 - C. Schedule K-1
 - D. Form 4797
3. Which form computes S corporation shareholder stock and debt basis?
- A. Form 7203
 - B. Form 1099-NEC
 - C. Schedule L
 - D. Form W-2
4. Carter pays its owner a \$150,000 salary. Where would the salary ordinarily appear as an employee payment?
- A. Form 7203
 - B. Form W-2
 - C. Schedule M-2
 - D. Form 4562
5. A \$200,000 depreciation deduction may reduce taxable income even though Carter paid for the equipment in an earlier year.
- A. True
 - B. False
6. A shareholder guarantees Carter's bank loan. Does the guarantee alone ordinarily create shareholder debt basis?
- A. Yes
 - B. No
7. Carter sends the owner \$100,000 as repayment of documented loan principal. What is the first analytical step?
- A. Call it salary
 - B. Call it a distribution
 - C. Verify the bona fide debt, debt basis, and payment trail
 - D. Add it to gross receipts
8. Which statement best distinguishes gross receipts and net income?
- A. Both are the same as cash available to the owner
 - B. Net income reflects deductions and tax adjustments to revenue
 - C. Gross receipts include only distributions

D. Net income is always larger

9. Where would an individual generally report S corporation pass-through income from a K-1?

A. Schedule E of Form 1040

B. Form W-2

C. Form 4562 only

D. Schedule L

10. A K-1 shows a loss. What should be checked before claiming it on the individual return?

A. Only the company bank balance

B. Basis and other applicable loss limitations

C. Only the W-2

D. Whether cash distributions exceed revenue

11. Which records best test whether an owner's receipt was salary, a distribution, or loan repayment?

A. Only a K-1

B. Payroll, general ledger, loan records, and bank statements

C. Only Form 4797

D. Only the depreciation schedule

12. Is Schedule L book equity interchangeable with shareholder stock basis?

A. Yes

B. No

Answer Key

1. **B** — Allocated pass-through income may be taxable without a distribution.
2. **C** — The K-1 allocates shareholder tax items.
3. **A** — Form 7203 addresses stock and debt basis.
4. **B** — Wages are reported on Form W-2.
5. **A** — Depreciation is a tax deduction that need not match current cash spending.
6. **B** — A guarantee alone generally is insufficient.
7. **C** — Substance and records determine how a receipt should be characterized.
8. **B** — Net income is calculated after relevant deductions and adjustments.
9. **A** — Schedule E generally carries S corporation pass-through income to Form 1040.
10. **B** — Basis and other limitations can defer a loss.
11. **B** — The underlying transaction records test the classification.
12. **B** — Book equity and tax basis are different measures.

Reference sources

IRS Instructions for Form 1120-S: <https://www.irs.gov/instructions/i1120s>

IRS Shareholder Instructions for Schedule K-1: <https://www.irs.gov/instructions/i1120ssk>

IRS Form 7203 information: <https://www.irs.gov/forms-pubs/about-form-7203>

IRS Publication 946: <https://www.irs.gov/publications/p946>