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Documenting S Corporation Shareholder Basis

As Protection Against
an IRS Audit

American Institute of Certified Public Accountants
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Basis for S Shareholders

The Basics:

S shareholder losses limited to basis in

- Stock and
- Debt of the S corp. to the shareholder [Sec. 1366(d)]

Basis of stock reduced first, then debt

Any current undistributed income restores prior basis reductions of debt before increasing stock basis [Sec. 1367(b)(2)]

Note that Schedule M-2 is not a reflection of basis





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Example 1

Losses offset stock basis first, then debt
Shareholder withdraws \$25,000 of the
current income of \$40,000:

	<u>Stock</u>	<u>Debt</u>
Original basis	\$50,000	\$100,000
Prior year losses	(50,000)	(30,000)
Current income: \$40,000		
Less distribution <u>(25,000)</u>		
Excess restores basis in debt		\$15,000





S Shareholder Stock Basis

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Calculated at shareholder level, per shareholder
Losses and deductions limited by basis:

- Carry forward indefinitely
- Treated as passing from S corp. to that shareholder in next year [IRC Sec. 1366(d)]

Gain on sale of S corporate stock does not increase basis or otherwise allow use of suspended losses

Carryover loss expires when shareholder gives all of his/her stock to another

- Exception for divorce [IRC 1366(d)(2)(B)]





S Shareholder Stock Basis

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Stock basis calculated per share

Spillover rule: But if reductions to a share exceed its basis, excess applied to reduce basis of other shares, but not below zero [Reg. 1.1367-1(c)(3)]

Example 2: Spillover Rule

	Shareholder C			
	<u>Sh. 1</u>	<u>Sh. 2</u>	<u>Sh. 3</u>	<u>Total</u>
Basis – Jan. 1	\$ 0	\$20K	\$50K	\$70K
Loss of \$30K:				
1) Pro-rate	(10K)	(10K)	(10K)	(30K)
2) Spillover	10K	(5K)	(5K)	0
Basis – Dec. 31	\$ 0	\$ 5K	\$35K	\$40K





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Adjustments to Stock Basis

General rule:

- Income +
- Distributions < - >
- Nondeductibles < - >
- Deductibles < - >

**May elect to
reorder per
Reg. 1.1367-1(g)**

No requirement to c/o nondeductibles

Election to reorder basis adjustment

- Consequence: get deductibles first but c/o nondeductibles if insufficient basis.
- Permanent election





Ex 3-Order of Adjustments to Stock Basis

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	<u>Gen. Rule</u>	<u>Election To Reorder</u>
Beg. basis	\$40,000	\$40,000
– Nondeductibles	(15,000)	
– Deductibles (\$30,000)	<u>(25,000)</u>	(30,000)
– Nondeductibles		<u>(10,000)</u>
Ending basis	<u>\$ 0</u>	<u>\$ 0</u>
Carryforward	<u>\$ (5,000)</u>	<u>\$ (5,000)</u>

Without election to reorder, no requirement to c/o non-deductibles (if nondeductibles exceed the basis, prior to applying deductible expenses)

Deductibles reduce stock basis b/4 nondeductibles w/ election

- Consequence: Nondeductibles last, but carryforward if insufficient basis
- Permanent election

Election is per shareholder





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No Earnings & Profits

If there are no C corporation E&P, AAA is not significant to current distributions

- AAA computation will be necessary if S corp reorganizes tax-free with another corp that has E&P
- AAA is also important if the corporation revokes the S election and distributions are made within the post-termination transition period

Tax-free distributions during the PTTP are limited to AAA and shareholder basis

Basis in stock is the only limiting factor to current tax-free distributions





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S Corp w/ Accumulated E&P

If the corporation has accumulated earnings and profits, AAA is relevant

- Accumulated E&P can only be created while the corporation was a C corporation
- Not equal to retained earnings

Determined instead based upon earnings and profits accounting methods

When a C corporation elects S status, compute earnings and profits





S Corp. Distributions

S corp. with no prior C corp. E&P

- Distributions are first a return of stock basis
- Excess treated as a gain from sale of stock

[IRC Sec. 1368(b)]

Example 4

Stock Basis

Beginning Jan. 1	\$ 10K	
Income per K-1	50K	
Distribution of \$65K:		
1 st : Rtn. of basis	(60K)	Tax free
2 nd : Capital gain	<u>0</u>	\$5,000 LTCG
	<u>\$ 0</u>	

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S Corp. Distributions

Ordering rules if prior C corp. E&P:

S Corp.

1. Accum. Adj. Acct. (AAA)
2. Accum. E&P
3. Excess

Indiv. Shareholder

1.
 - a. To stock basis
 - b. Excess = gain
2. Dividend
3.
 - a. To stock basis
 - b. Excess = gain





S Corp. Distributions

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Definition of AAA (Reg. 1.1368-2):

Quick definition: Undistributed S net income

Starts at \$0 on first day of first S year

AAA can be negative due to losses/ deductions
(but not due to distributions)

Corporate level account—no s/h “entitled” to
AAA

OAA—Other Adjustments Account





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S Corp. Distributions

Example 5: Net Income

	<u>S Corp.</u>		<u>Sole Shareholder</u>	
	<u>AAA</u>	<u>AE&P</u>	<u>Basis</u>	<u>Income</u>
Jan. 1	\$10,000	<u>\$15,000</u>	\$12,000	\$ 0
Net income-1st	6,000		6,000	<u>6,000</u>
Distribution	<u>(9,000)</u>		<u>(9,000)</u>	
Dec. 31	<u>\$ 7,000</u>	<u>\$15,000</u>	<u>\$ 9,000</u>	<u>\$6,000</u>





S Corp. Distributions

Example 6: Net Loss

	<u>S Corp.</u>		<u>Sole Shareholder</u>	
	<u>AAA</u>	<u>AE&P</u>	<u>Basis</u>	<u>Income</u>
Jan. 1	\$10,000	<u>\$15,000</u>	\$12,000	\$ 0
Distribution-1st	(9,000)		(9,000)	
Net Loss	<u>(6,000)</u>		<u>(6,000)</u>	<u>(3,000)</u>
Dec. 31	<u>\$(5,000)</u>	<u>\$15,000</u>	<u>\$ 0</u>	<u>\$(3,000)</u>
			+ Carryover loss	<u>\$(3,000)</u>

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S Corp. Distributions

Example 7: Distribution Exceeds AAA

	<u>S Corp.</u>		<u>Sole Shareholder</u>	
	<u>AAA</u>	<u>AE&P</u>	<u>Basis</u>	<u>Income</u>
Jan. 1	\$10,000	\$15,000	\$12,000	\$ 0
Distrib. \$13K	1) (10,000)		(10,000)	
	2)	(3,000)		3,000
Net Loss	<u>(6,000)</u>		<u>(2,000)</u>	<u>(2,000)</u>
Dec. 31	<u>\$(6,000)</u>	<u>\$12,000</u>	<u>\$ 0</u>	<u>\$(1,000)</u>
		+ Carryover loss		\$ (4,000)

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S Corp. Distributions

Example 8: AAA exceeds basis

	<u>S Corp.</u>		<u>Sole Shareholder</u>	
	<u>AAA</u>	<u>AE&P</u>	<u>Basis</u>	<u>Income</u>
Jan. 1	\$10,000	\$15,000	\$ 8,000	\$ 0
Distrib. \$13K	1) (10,000)		(8,000)	2,000 LTCG
	2)	(3,000)		3,000 DIV

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S Corp. Distributions

Example 9: Negative AAA

	<u>AAA</u>	<u>AE&P</u>
Jan. 1	\$(100,000)	\$ 50,000
Net Income	<u>80,000</u>	
Distribution: \$35K		<u>(35,000)</u> Div.
Dec. 31	<u>\$ 20,000</u>	<u>\$ 15,000</u>





S Corp. Distributions

Example 10: Distribution of exempt income

	<u>S Corp.</u>		<u>Sole Shareholder</u>	
	<u>AAA</u>	<u>AE&P</u>	<u>Basis</u>	<u>Income</u>
Jan. 1	\$10,000	\$50,000	\$12,000	\$ 0
Taxable Income	5,000		5,000	5,000
Exempt income (\$50K)	0		50,000	
Distribution: \$40K	<u>(15,000)</u>	<u>(25,000)</u>	<u>(15,000)</u>	<u>25,000</u>
Dec. 31	<u>\$ 0</u>	<u>\$25,000</u>	<u>\$52,000</u>	<u>\$30,000</u>

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Other Loan Basis Rules

Only loans outstanding at year-end provide basis for losses

If multiple loans by a shareholder, loss reduces each debt in proportion to its ending basis

If multiple loans with prior basis reduction, current income:

1. First increases basis of any loan currently repaid
2. Then increases loan basis in proportion to prior basis reductions (Reg. 1.1367-2)





Example 11

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	<u>Shareholder C</u>		
	Loan <u>1</u>	Loan <u>2</u>	Loan <u>3</u>
Face	\$10K	\$20K	\$20K
Prior losses	<u>(10)</u>	<u>(20)</u>	<u>(5)</u>
Basis Jan. 1	\$ 0	\$ 0	\$15K
Current income: \$29K			
1. Loan 2 repaid (\$20K)		+ \$20K	
2. Allocate excess (\$9K)	+\$ 6K		+\$ 3K
Allocated based upon prior losses	(10/15)		(5/15)



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Repay Reduced-Basis Debt

Partial repayment is proportionately gain and return of basis

– Rev. Rul. 68-537

Character of gain:

Open advances (unwritten debt):

Ordinary Income [Rev Rul 68-537]

Written debt: Capital gain [Rev Rul 64-162]





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Example 12

	Shareholder D	
	Stock	Loan
Original	\$10,000	\$50,000
Prior losses	<u>(10,000)</u>	<u>(40,000)</u>
Current basis	\$ 0	\$10,000
Repay \$20,000 on note:		
Return of basis (1/5)		\$ 4,000
Gain (4/5)		\$16,000

% return of basis based upon \$10,000 basis in note divided by \$50,000 face value





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Open Account Debt

Open advances treated as one debt if $< \$25,000$

Open account debt treated as separate debts at the beginning of the year following the year in which the ending balance exceeds $\$25,000$

- $\$25,000$ threshold applies to each shareholder
- If threshold exceeded, Reg. 1.1367-2(a) treats each advance as a separate debt

Repayments need to be allocated to all debts proportionately





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