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Calculating S Corp Stock and Debt Basis: Avoiding Loss Limitations and Excess Distributions

WEDNESDAY, FEBRUARY 13, 2019, 1:00-2:50 pm Eastern

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Calculating S Corp Stock and Debt Basis

FEBRUARY 13, 2019

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Mechanics of Calculating Stock Basis

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Tracking Stock Basis

- Importance of accurately tracking stock basis
  - Ability to take losses: in order to take losses shareholders must demonstrate they have adequate stock and debt basis
  - Determine if distributions are tax free
  - Basis needs to be established to determine the proper gain/loss on disposition of the stock
  - Recent IRS campaign (2017) – LB&I announced they will be launching a campaign directed at shareholders of S Corporations taking losses and deductions in excess of basis
- It's the shareholder's responsibility to track basis; it is not the corporation's responsibility
- The shareholder may have a different AMT basis than regular tax basis

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Mechanics of Stock Basis

- Basic formula for calculating stock basis in an S Corporation

Beginning Basis

+ Increased by items of income

- Decreased by non-dividend distributions

- Decreased by non-deductible/non-capital expenses

- Decreased by items of deduction and loss

Ending Basis

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Creation of Basis

- A shareholder's initial basis is determined by how the shareholder acquired the shares:
  - Purchase of shares
  - Shares from capitalization
  - Electing "S" Corporation status
  - Exchanged for Services
  - Gift
  - Inheritance

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Purchase of Shares

- The amount of money paid is basis in the shares.
- A note to the S corporation or subscribing for more stock does not have economic substance and therefore does not create basis.
  - There must be an "economic outlay" whereby the transaction leaves the taxpayer poorer in some material sense (Rev. Rul. 81-187).

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Creation of Basis

- Basis from Capitalizing the S corporation
  - If shares were acquired when the corporation was capitalized in a § 351 transaction, basis in stock is equal to the property transferred to the corporation plus any gain recognized less any property received.
    - § 351 transaction is a tax free transfer of assets and liabilities in exchange solely for stock of the corporation where the shareholder(s) have control immediately following the transaction. Neither the corporation or the shareholder will have gain recognition if only stock is received.
    - If the shareholder receives anything other than stock "boot" a gain may be realized.

Creation of Basis

- On 1/1/19 David contributed $5,000 in cash and equipment with an adjusted basis of $15,000 to XYZ, a newly formed S Corporation in exchange for 100 shares of stock. The equipment was subject to a loan in the amount of $2,000, which XYZ assumed. The transaction qualified as a § 351 transaction. David's stock basis from formation is:

Cash contributed	$	5,000
Adjusted basis of property contributed		15,000
Less liability relief		(2,000)
Initial stock basis	$	18,000

- Basis in shareholder's stock when a corporation elects "s" status is carryover basis
  - Assume the same facts but XYZ did not elect "S" status until 1/1/2020. David's stock basis is the same as it was at 1/1/2019 because the "S" election does not effect stock basis. On election of "S" status, David's stock basis is still $18,000.

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Basis from Gifts of Stock

- Basis in gifted stock is usually the donors basis (carryover basis).
  - Any gift taxes attributable to the appreciation of the property are added to stock basis.
  - Suspended passive activity losses are added to basis.
  - If the FMV of the stock at the time of the gift is less than the basis, different basis amounts must be used when deducting losses or when stock is sold.
    - When FMV is less than the carryover basis, the FMV is considered to be basis for purposes of determining losses
    - When FMV is greater than the carryover basis, the carryover basis is used to determine gain

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Basis from Gifts of Stock

- On 12/31/2021 Jacob is gifted 100 shares of XYZ from his father, David. David's basis in the stock is $30,000 and the FMV of the stock is $20,000 on the date of gift.
  - If Jacob sells the stock for $15,000, he has a $5,000 loss on the sale. He must use the FMV of the stock as his basis for deducting losses.
  - If Jacob sells the stock for $35,000, he recognizes a gain of $5,000. He must use the donor's basis to calculate gain.
  - If Jacob sells the stock for any amount between $30,000 and $20,000 there is no gain or loss on the sale.
  - Jacob must track basis separately using both the FMV and carryover basis to determine what amount of gain or loss he must recognize if the stock is sold.

Basis from Inherited Stock or Services

- The basis of stock received from a deceased shareholder is the fair market value of the stock on the date of death or alternate valuation date (step-up in basis).

- Basis in stock received for services is measured by the fair market value of the stock (not the value of services provided).

  - Note: If only services are contributed in exchange for stock, the transaction will not qualify under § 351 for purposes of the control test.

Increases and Decreases to Stock Basis

- S Corporations must "pass-through" items on a per-share, per-day basis. Special allocations cannot be made.
- In general, items for the entire year are allocated equally to each day of the year and are then allocated to shareholders equally among the shares of stock outstanding during the year (commonly referred to as per-share, per-day). Basis adjustments are generally made at the end of the year.
- An election can be made (Specific Accounting Election) if there is a change in ownership during the year. This allows the S Corporation to allocate pass-through items to departing shareholders for the specific period of time the stock was owned.
  - Requires consent of all shareholders affected by disposition of stock
  - Must be termination of an entire interest or must meet definition of "qualifying disposition"

Increases in Basis

- S Corporation stock is increased by non-separately and separately stated items of income and gain.
  - Non-separately stated income (ordinary)
  - Separately stated income
  - Tax exempt income
  - Excess deduction for depletion over basis of property subject to depletion (except oil and gas properties)
- IRC § 1367 provides a special rule that if an item is required to be reported on a shareholder's return in gross income, basis is only increased if the shareholder actually includes that item into income.

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Increases in Basis

- Example: Maggie has basis in DEF company at 1/1/19 of $3,000. During the year DEF earns $2,000 in ordinary income from business operations, a §1231 gain of $50 and tax exempt income of $45. Maggie's basis before decreases is:

Basis 1/1/19	$	3,000
Ordinary income (non-separately stated)		2,000
§ 1231 gain (separately stated)		50
Tax exempt income (separately stated)		45
Basis before distributions and loss/deduction	$	5,095

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Cancellation of Debt Income

- When discharge of an S-Corporations debt (COD income) results in income to the corporation that is passed through the shareholder it can increase his basis by the amount included on his return.

  - During 2020, XYZ has $6,000 in cancellation of debt income. The COD income is passed through to Jacob, who reports the income on his personal tax return. His stock basis is increased by the $6,000.

  - Assume the same facts however, XYZ is insolvent so the COD income is excluded. Jacob does not receive an increase in basis for the $6,000 in COD because it was not picked up in income on his personal return

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Decreases in Basis

- A shareholder’s basis is decreased by non-dividend distributions.
  - S corporations that were formally C Corporations that have accumulated E&P may make dividend distributions.
  - Dividend distributions have no effect on stock basis. The corporation is responsible for telling a shareholder the amount of non-dividend and dividend distributions. A 1099-DIV should be issued for dividend distributions

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Decreases in Basis

- S Corporation stock is decreased by non-separately and separately stated items of loss or deduction. Loss deductions available to be taken on the shareholder's return are not considered until basis is reduced for non-dividend distributions
  - Non-deductible and non-capital expenses
  - Non-separately stated losses
  - Separately stated losses
  - Depletion for oil & gas
  - **Basis cannot be reduced below zero**. Non-dividend distributions in excess of basis create capital gain. Losses in excess of basis are suspended until basis the shareholder has sufficient basis (stock or debt).

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Decreases in Basis

- Example: David has a beginning basis of $19,000 in XYZ. No items of income or distribution were passed through during 2019. David received a K-1 showing the following amounts: ordinary loss of $4,400, rental loss of $2,000, non-deductible expenses of $250 and $200 in long term capital losses. David's basis is calculated as follows (assuming no 1.1367-1(g) election was made):

Basis at 1/1/2019	$ 19,000
Non-deductible expenses	(250)
Ordinary loss (non-separately stated)	(4,400)
Rental Loss (separately stated)	(2,000)
Long term capital losses	(200)
Basis at 12/31/2019	$ 12,150

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Decrease in Basis - IRD

- Income in respect to a decedent (IRD) general consists of items of income that a decedent was entitled to at death but were not included on the final return because the decedent's method of accounting was different than that of the S Corporation. IRD is included in a decedents assets on the estate tax return and is included in the income of the beneficiary.

  - Usually interest and dividend income from investments or installment sale income

  - A shareholder who inherits S Corporation stock treats IRD as his pro-rata share of income as though the items were acquired directly from the decedent.

  - The beneficiary's stepped up basis is reduced by items of IRD.

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Decrease in Basis - IRD

- QRS is a cash basis S Corporation with a calendar year end. Bob, the sole shareholder, dies on June 30th, 2019 and his stock is passed on to his beneficiary, Alice. QRS held a CD with $200 of interest payable annually. At the date of Bob's death, QRS is valued at $10,000 including the accrued interest. Bob's basis was $1,200 at his date of death.

- If a specific accounting election is not made, there is no IRD to Alice because income is passed through on a per share per day basis (assuming the cash is received by December 31).

- If QRS makes the specific accounting election, none of the $200 is included in the final K-1 for Bob. Instead, Alice has $100 of IRD from the interest that was earned (but not received) during the portion of the year Bob was a shareholder.

Basis to Alice FMV date of death	10,000
Pass-through interest income	200
IRD	(100)
Basis at end of the year	10,100

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Ordering Rules under Reg. 1.1367-1(f)

- Stock basis is adjusted annually, in the following order (Reg. 1.1367-1(f) for years beginning post 8/18/98):

  - Any increase in basis attributable to income items and the excess of non–oil and gas depletion deductions over the basis of the property subject to depletion;

  - Any decrease in basis attributable to S corporation distributions that are not taxable to the shareholder;

  - Any decrease in basis attributable to nondeductible, noncapital expenses and the oil and gas depletion deduction; and

  - Any decrease in basis attributable to separately stated and non-separately stated items of loss or deduction that are taken into account by the shareholder.

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Ordering Rules under Reg. 1.1367-1(f)

- Ordering is important because it causes the tax effects of distributions to be determined by reference to basis after adjustment for pass-through income and gain items (not losses or deductions).

- Losses in excess of basis (assuming no debt basis) after considering income, distributions and non-deductible expenses become suspended and can be used in future years when the shareholder has sufficient basis

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Ordering Rules under Reg. 1.1367-1(f)

- Maggie has a stock basis (no debt basis) in DEF of at 1/1/20 of $5,095. Her share of pass-through items for 2020 is ; $10,000 ordinary loss, $300 rental income, $200 interest income, $700 in non-deductible expenses and she received a distribution of $4,000 during the year.

Basis at 1/1/2020		$	5,095
Increase:			
Rental Income	300		
Interest Income	200		
			500
Basis before distributions			5,595
Distributions			(4,000)
Decrease:			
Non-deductible expense	(700)		
Ordinary loss	(895)		
			(1,595)
Basis at 12/31/2020		$	-

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Ordering Rules under Reg. 1.1367-1(f)

- Maggie can only take $895 in losses on her personal return for 2020 because her stock basis is reduced to zero. The remaining $9,105 in losses is suspended and will be available for use in a year where she has sufficient basis.

- The ordering rules are important to determine if Maggie's distribution is tax free. Since she has adequate stock basis after items of income are added to her beginning of the year basis, distributions are non-taxable. Items of current year deduction and loss are not considered when determining stock basis for the tax effect of distributions. Prior regulations (pre 8/18/98) considered basis reductions for distributions last.

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Ordering Rules under Reg. 1.1367-1(f)

- To illustrate the effect of the current ordering rules applied to distributions, assume the same fact pattern but instead of a $4,000 distribution Maggie received a $9,000 distribution (non-dividend)

Basis at 1/1/2020		$	5,095
Increase:			
Rental Income	300		
Interest Income	200		
			500
Basis before distributions			5,595
Distributions			(5,595)
Basis at 12/31/2020		$	-

- Maggie's stock basis before distributions is $5,595. Distributions are non-taxable to this amount. The remaining $3,405 of distributions in excess of basis is treated as a capital gain. The entire amount of ordinary loss is suspended and carried forward indefinitely. Non-deductible items do not carryforward.

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Ordering Rules under Reg. 1.1367-1(g)

- Reg. 1.1367-1(g) allows for an alternate ordering rule
  - A shareholder is permitted to make an election to reduce basis by items of loss or deduction before reducing basis by any non-deductible expenses. Non-deductible/non-capital items will carryforward and reduce basis in future years.
  - The election is made by attaching a statement to the shareholder's timely filed original or amended tax return. Once the election is made it is effective for all future years for that S Corporation unless the IRS gives permission to change
  - The election is made by the shareholder, not the corporation
  - If the election is made, non-deductible items in excess of basis must be carried over to future years to reduce basis (the "cost" of making the election)

Ordering Rules under Reg. 1.1367-1(g)

- Assume the same facts as the prior example. If Maggie makes an election to deduct losses and deductions before non-deductible items she is able to take a loss of $1,595 for 2020. The remaining loss of $8,405 is suspended and carried forward indefinitely. The non-deductible expenses of $700 are carried forward and will reduce basis in future years

Basis at 1/1/2020		$	5,095
Increase:			
Rental Income	300		
Interest Income	200		
			500
Basis before distributions			5,595
Distributions			(4,000)
Decrease:			
Ordinary loss	(1,595)		
			(1,595)
Basis at 12/31/2020		$	-

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Multiple Stock Blocks

- A shareholder may own shares of stock with different bases and holding periods (acquired in different blocks at different times)

- While it is required, a shareholder may benefit from maintaining separate basis for different blocks of stock if he would like to do future gifting or sell blocks of stock.

- Stock increases and decreases are applied separately to each share
  - Amounts are still applied on a per share, per day basis
  - Reductions to basis cannot reduce a share's basis below zero. If the reductions exceed basis of a share, the excess shifts to the other shares. This excess is allocated based on the relative remaining basis in the other shares

Multiple Stock Blocks

- Example: Bailey acquired ABC stock at different dates. The first block of shares was purchased for $2,000, the second for $5,000 and the third for $6,000. Bailey is allocated an ordinary loss of $9,000 for 2019.

	Block 1	Block 2	Block 3
Basis at 1/1/2019	$ 2,000	$ 5,000	$ 6,000
Loss allocated	(3,000)	(3,000)	(3,000)
Excess (loss)/remaining basis	(1,000)	2,000	3,000
Shift to other shares		(400)	(600)
Basis at 12/31/2019		$ 1,600	$ 2,400

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Effect of Credits on Basis

- General business credits do not effect basis, however they may be limited at the shareholder level due to the shareholder’s tax liability, passive losses, etc.
- However, if a credit or credit recapture requires a basis adjustment of an asset, that adjustment will also adjust the shareholder’s basis in the stock.
- Credits that reduce operating expenses, such as the incremental R&D credit, do not decrease stock basis. Stock basis is inadvertently reduced by the non-deductible portion of the expense

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Effect of Credits on Basis

- Example: Bailey owns 100% of ABC, an S Corp in which she materially participates. Bailey receives a K-1 from ABC reporting ordinary loss of $2,000 and $10,000 in qualified rehabilitation expenditures for remolding of a historic building. The expenditures creates a $2,000 credit and the building's basis must be reduced by the same amount. Bailey's basis at 1/1/2020 is $2,000.

Basis at 1/1/2019		$ 4,000
Ordinary Loss		(2,000)
Reduction in basis of asset from credit	*	(2,000)
Basis at 12/31/2019		$ -

*the corporation's AAA account is reduced by the same amount

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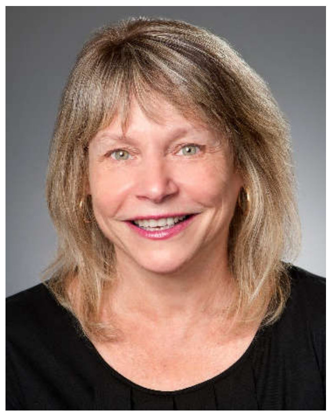
Calculating S Corp Stock and Debt Basis Avoiding Loss Limitations and Excess Distributions and Loss Limitation Rules Applicable to S Corporation Shareholders



Tracking Basis Against Distributions to Avoid Current Double Taxation

- An S corporation, generally, is not subject to federal income taxes. Instead the annual items of an S corporation's income, gain, loss, deduction and credit pass through to the S corporation's shareholders. These shareholders then report the pro rata share of each item on the shareholder's income tax return.

- The determination of whether an S corporation shareholder recognizes taxable income on a distribution from the S corporation depends upon the shareholder's tax basis in his or her S corporation stock, the S corporation's earning and profits ("E&P") and the accumulated adjustments account (the "AAA").

- An S corporation will only have E&P if it was previously a C corporation or if the S corporation acquired the assets of a C corporation in a transaction covered by Section 381 of the Internal Revenue Code of 1986, as amended (the "Code").

- If an S corporation does not have any current or accumulated E&P, then the tax treatment of a distribution from the S corporation to its shareholders will depend on the shareholders' tax basis in the S corporation's stock.

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Distributions Generally

- Under Code Section 1368, a distribution from an S corporation to a shareholder gives rise to three possible consequences:
  1. A tax-free reduction in the shareholder's tax basis in his or her S corporation stock;
  2. A taxable dividend; or
  3. Gain from the sale of stock.
- One distribution may result in all three. The categories are not mutually exclusive.

Key Attributes

- In order to determine which category or categories a distribution will fall into depends on certain attributes of the corporation and the shareholders
- The shareholder attributes are stock and debt basis and previously taxed income (“PTI”).
- The corporate attributes are E&P and the AAA.
- The concept of PTI only applies to pre-1983 S corporations and will not discussed further in these slides.

Stock Basis

- Under Code Section 1367, an S corporation shareholder is required to adjust his or her S corporation stock basis annual to reflect the items of income, gain, loss, deduction and distributions allocated to the shareholder.
- The purpose of this adjustment is to preserve the fact that there should only be a single level of tax for an S corporation.
- Increases to Basis
- The following items increase a shareholder's tax basis in his or her S corporation stock:
  - Capital contributions;
  - Separately stated items of income (including tax-exempt income) and non-separately stated computed income and
  - The excess of deductions for depletion over the basis of the property subject to depletion.

Stock Basis

- The following items decrease a shareholder's tax basis in his or her S corporation stock:
  - Distributions, other than those taxed as dividends;
  - Separately stated items of loss and deductions and any nonseparately computed loss;
  - Nondeductible expenses that are not properly chargeable to a capital account and
  - The amount of the depletion deduction for any oil and gas property held by the S corporation to the extent the deduction does not exceed the shareholder's share of its adjusted basis in property.
- These adjustments are determined as of the close of the corporation's taxable year and are generally effective as of that date under Treasury Regulations Section 1.1367-1(d). However, if a shareholder disposes of his or stock during the taxable year, the adjustments are effective immediately prior to the disposition.

Importance of Order

- Crucial to the determination of whether a distribution will be taxable to the shareholder, is the order in which the adjustment to basis are required to be made.
- This is because even though distributions reduce S corporation stock basis, the shareholder's tax basis in the stock will determine if the distribution is taxable.
- Order of Adjustments
- For taxable years beginning on or after August 18, 1998, except as provided in the regulations, Treasury Regulations Section 1.1367-1(f) provide that stock basis is first adjusted for required increases to basis, then basis is reduced by non-dividend distributions before any reduction for losses or nondeductible expenses. Under the general rule, a shareholder's tax basis in its S corporation stock is then reduced by non-deductible expenses and the oil and gas depletion deduction before being reduced for any separately stated items of loss and deduction and nonseparately stated losses.

Basis Cannot Be Reduced Below Zero

- Under Code Section 1367, an S corporation shareholder's tax basis in his or her stock cannot be reduced below zero. To the extent that losses exceed the tax basis remaining in the stock after reducing the stock basis for distributions and non-deductible expenses, the excess loss can be used to reduce any tax basis that the shareholder has in the S corporation's indebtedness to the shareholder. If the losses exceed the S corporation shareholder's tax basis in his or her stock and debt, any excess losses are suspended and carried forward, indefinitely.

Basis Cannot Be Reduced Below Zero

- Example: A owns 100% of the stock of X, an S corporation. A begins 2019 with a stock basis of $10,000 in his X stock. During 2019, X generates $3,000 of ordinary income, and $10,000 of long-term capital loss and makes a distribution of $5,000 to A.

- For 2019, A increases his beginning stock basis of $10,000 for the $3,000 of ordinary income. This $13,000 basis is then decreased by the $5,000 distribution, reducing A's stock basis to $8,000. A then reduces his stock basis to zero for $8,000 of the long-term capital loss. The remaining $2,000 of capital loss is carried forward and will be treated as a new $2,000 capital loss in 2020.

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Earnings and Profits

- After the Subchapter S Revision Act of 1982, after January 1, 1983, an S corporation no longer generates E&P.
- As stated previously, an S corporation will only have E&P if it was previously a C corporation and generated E&P during that time or if the S corporation acquires the assets of a C corporation that had generated E&P, in a transaction that qualifies under Code Section 381.
- Please note that E&P is not synonymous with taxable income or retained earnings. E&P is a measure of a corporation's "economic income" so as to enable a differentiation of distributions that should be taxed as dividends from those distributions that represent a return of a shareholder's capital. Each year, a C corporation is required to compute its E&P by adjusting taxable income to reflect the economic effect of the S corporation's items of income, gain, loss, deduction and credit.

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Accumulated Adjustments Account

- If an S corporation has any accumulated E&P at the time when the S corporation makes an S election, then distributions from the S corporation out of the E&P will be treated as a taxable dividend to the S corporation's shareholder when it is distributed. The purpose of the accumulated adjustments account is to permit an S corporation to distribute the S corporation's income before being required to treat the distribution to be deemed to be made from E&P, thus deferring the distribution being taxed as a taxable dividend. This deferral is limited to the positive balance of the S corporation's accumulated adjustment account ("AAA").

- The Subchapter S Revision Act of 1982 created the AAA to allow the S corporation to track the cumulative taxable income earned by an S corporation, but not yet distributed to the S corporation's shareholders.

Accumulated Adjustments Account

- A newly electing S corporation will always start with a zero balance in its AAA, whether it has E&P or retained earnings from a prior C corporation year.

- It is especially important to maintain the correct balance in the AAA when an S corporation has E&P, because it is the AAA that will serve to distinguish between those distributions made from the S corporation's income, which should not be subject to double taxation, from the distributions made from C corporation's E&P, which should be taxed as a dividend.

Adjustments to AAA

- Each year an S corporation is required to make adjustments to its AAA, in a manner similar to the adjustments that the S corporation's shareholders are required to adjust stock basis.

- However, the AAA is a corporate level tax attribute that is not affected by shareholder level transactions such as sales or exchanges.

- An S corporation is required to increase its AAA by the same items that result in an increase in stock basis, except that there is no increase for capital contributions or tax-exempt income.

Adjustments to AAA

- An S corporation is required to decrease its AAA by the same items that decrease tax basis, except that there is no reduction for nondeductible expenses related to tax-exempt income and federal taxes attributable to any tax year in which the corporation was a C corporation.

- AAA can be reduced below zero, but only by losses, not by distributions.

Order of AAA Adjustments

- In computing AAA, the S corporation must determine if it has a “net negative adjustment for the year. A “net negative adjustment: is the excess of reductions to the AAA balance, other than for distributions, over the increases for the year. If the increases to the AAA exceed the reductions, other than for distributions, then this would be a “net positive adjustment,” but the Treasury Regulations do not use this term.

- If the S corporation has a net positive adjustment for the year, the AAA is adjusted for the net positive adjustment before reducing the AAA for any distributions made for the year. Under this rule, it is more likely that a distribution will be treated as having been made from AAA and not from E&P, which could result in a taxable dividend.

Order of AAA Adjustments

- If the S corporation has a net negative adjustment for the year, the AAA is reduced by the distribution, but not below zero, before reduction for the net negative adjustment. The effect of this rule is that there will be a higher AAA balance when the distribution made, making it less likely that the distribution will be a taxable dividend made from E&P.

Taxation of S Corporation Distributions

- The Treasury Regulations under Code Section 1368 differentiate between distributions made from an S corporation without accumulated E&P and distributions made from an S corporation with accumulated E&P. Therefore, the first step in determine the tax consequences of a distribution by an S corporation is to ascertain whether the S corporation has accumulated E&P.

Distributions From An S Corporation With No Accumulated E&P

- If an S corporation has no accumulated E&P, then determining the tax treatment of a distribution to the S corporation's shareholders is relatively simple.
- The shareholder of an S corporation without accumulated E&P determines the tax consequences of such distribution under a two-tier approach.
  1. The distribution is a tax-free reduction of the shareholder's tax basis in the S corporation's stock; then
  2. Any distribution in excess of the shareholder's tax basis in the S corporation's stock is treated as gain from the sale or exchange of the stock.

Distributions From An S Corporation With No Accumulated E&P

- Example: A owns 100% of the stock of X, an S corporation. On January 1, 2019, A has a tax basis in his X stock of $40,000 and X has an AAA balance of $20,000. X has been an S corporation since its formation and has no accumulated E&P. During 2019, X allocates to A $40,000 of ordinary income and $30,000 of long-term capital loss and distributes $50,000 to A.
- Since X does not have any accumulated E&P, X's AAA balance is irrelevant in determining the taxability of the $50,000 distribution. The $50,000 distribution will be treated as a tax-free reduction of A's tax basis in the X stock, with any excess being treated as gain from the sale or exchange of the X stock.

Distributions From An S Corporation With No Accumulated E&P

- To determine the tax treatment, A must adjust his tax basis in the X stock. Under the Treasury Regulations, A first increases his beginning tax basis of $40,000 for the $40,000 of ordinary income allocated to A. A's $80,000 tax basis in the X stock is then reduced by the distribution of $50,000, before it is reduced by any losses or nondeductible expenses.

- A's remaining tax basis in the X stock of $30,000 is then reduced by the $30,000 of long-term capital loss to zero.

Distributions From An S Corporation With No Accumulated E&P

- Example: A owns 100% of the stock of X, an S corporation with no accumulated E&P. A has a zero tax basis in the X stock. In 2018, X generates $30,000 of income and A's tax basis in the X stock is increased to $30,000. In May 2019, X distributes the $30,000 to A. In 2019, X allocates $50,000 of ordinary loss. To determine the tax treatment of the $30,000 distribution, A must adjust the tax basis of his X stock.

- The $30,000 distribution in 2019 is a tax-free reduction of A's tax basis in the X stock. A's tax basis in the X stock is now zero. A may not use the $50,000 ordinary loss allocated to him for 2019. Instead, A must carry forward the $50,000 loss to 2020 where it will be treated as a new loss.

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Distributions From an S Corporation With Accumulated E&P

- If a distribution is made by an S corporation with accumulated E&P, the distribution must be analyzed to determine the source of the distribution in order to preserve the differentiation between the treatment of distributions of S corporation income, which should not be subject to another level of taxation, and distributions of C corporation E&P, which should be taxed as a dividend.
- This is accomplished by dividing the distribution into three tiers:
  - Tier 1: To the extent the AAA balance is positive, the distribution is treated as if made by an S corporation with no accumulated E&P.
  - Tier 2: Distributions in excess of the AAA are treated as dividends to the extent of the accumulated E&P.
  - Tier 3: Distributions in excess of accumulated E&P are treated as made by an S corporation with no accumulated E&P.

Distributions From an S Corporation With Accumulated E&P

- This rule permit an S corporation with accumulated E&P to distribute its remaining previously taxed but undistributed income before the S corporation will be deemed to have made a distribution of its accumulated E&P. However, this does not mean that the distribution will be tax-free. To determine the tax treatment of the distribution, the shareholder must adjust his or her tax basis in the S corporation stock.

Distributions From an S Corporation With Accumulated E&P

- Once a distribution has reduced an S corporation's AAA to zero, the rationale of the regulations is that since all of the S corporation's previously taxed income has been distributed, the next dollars distributed must be taxed as a dividend, until the accumulated E&P is reduced to zero.

Distributions From an S Corporation With Accumulated E&P

- After the accumulated E&P has been reduced to zero, the S corporation can no longer make a dividend distribution. Therefore, the distribution will again be measured against the shareholder's tax basis in the stock. The distribution will be tax-free up to the shareholder's tax basis in the stock and any excess will be treated as gain from the sale or exchange of the stock.

Examples

- Example 1: A owns 100% of X, an S corporation. On January 1, 2019, X has an AAA of $5,000 and prior accumulated E&P of $7,000. On January 1, 2019, A has an adjusted basis in X's stock of $12,000. During 2019, X allocates to A $6,000 of ordinary income and $4,000 of long-term capital loss. X also distributes $12,000 to A.
- To determine the tax treatment to A of the $12,000 distribution, the distribution must be divided into three tiers:
- Tier 1: The $12,000 distribution will be treated as being made by an S corporation without accumulated E&P to the extent of the AAA balance. Therefore, the AAA balance must be computed first.

Examples

- X's AAA balance of $5,000, must be adjusted. First, it must be determined if X has a net positive or a net negative adjustment for 2019. Because A's $6,000 of income exceeds its $4,000 of losses by $2,000, X has a $2,000 net positive adjustment. Thus, X increases its AAA by $2,000 to $7,000.
- Therefore, the first $7,000 of the $12,000 distribution is treated as being made by a corporation without accumulated E&P. This amount will not be treated as a dividend. However, to determine its tax treatment to A, A must compute his or her tax basis in the X stock.

Examples

- Tier 2: The $5,000 of the distribution in excess of X's AAA is treated as having come from X's accumulated E&P balance of $7,000 and is treated as a dividend to A.
- Tier 3: Because the distribution does not exceed X's accumulated E&P, no portion of the distribution is allocated to Tier 3.

Examples

- Next, A must adjust his stock basis to determine the tax treatment of the distribution under Tier 1.
- A's beginning tax basis in the X stock of $12,000 is first increased by the $6,000 of ordinary income to $18,000. The $7,000 Tier 1 distribution is treated as a tax-free reduction of A's tax basis in the X stock to $11,000. A's tax basis in the X stock is then further reduced by the $4,000 long-term capital loss to $7,000.
- Where a distribution exceeds both the AAA and the accumulated E&P, the remaining distribution is treated as having been made from an S corporation with no accumulated E&P.

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Examples

- Example 2: A owns 100% of the stock of X, an S corporation. On January 1, 2019, X has $1,200 of AAA and accumulated E&P of $1,000. On January 1, 2019, A has an adjusted tax basis in the X stock of $1,500. During 2019, X allocates $4,000 of ordinary income and $5,500 of long-term capital loss to A. X also makes a distribution of $3,000 to A.
- In 2019, X had $4,000 of ordinary income and a $5,500 long-term capital loss, for a net negative adjustment of $1,500. X is required to reduce its AAA for the distribution, before accounting for the net negative adjustment.

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Examples

- X reduces its $1,200 in AAA to zero, but distributions cannot reduce AAA below zero. Therefore, only the first $1,200 of the $3,000 distribution is included in Tier 1. Once the AAA has been reduced to zero by the distribution, X must next reduce its AAA for the net negative adjustment of $1,500, reducing the AAA to a negative $1,500.
- The next $1,000 of the distribution is deemed to come from X's accumulated E&P under Tier 2 and is taxed to A as a dividend.
- The remaining $800 of the distribution is included in Tier 3. Any future distribution from X will be treated as having been made from an S corporation without accumulated E&P.

Examples

- To determine the tax treatment of the $2,000 distribution that is not treated as a dividend, A must determine his tax basis in the X corporation stock.
- A's beginning tax basis of $1,500 is first increased by the $4,000 of ordinary income to $5,000. This basis is then reduced by the distribution of $2,000 to $3,000. Therefore, both the Tier 1 distribution and the Tier 3 distribution will be treated as a tax-free return of basis. The $3,000 tax basis is then reduced to zero by the $5,500 long-term capital loss. The remaining $2,500 loss is carried forward and treated as a new long-term capital loss in 2020.

Examples

- Where an S corporation begins a year with a negative AAA, the AAA must be restored to a positive balance before the corporation can make a non-dividend distribution.

Loss Limitation Rules Applicable to S Corporation Shareholders

- There are three sets of rules that limit the ability of a S corporation shareholder to claim losses that are generated from the operations of the S corporation. These are the basis limitation rules, the passive loss rules and the at-risk rules.

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Loss Limitation Rules Applicable to S Corporation Shareholders

Loss Limitation Rules

- The shareholder of an S corporation cannot claim a loss to the extent that the loss exceeds the shareholder's tax basis in his or her S corporation stock and the shareholder's tax basis in any indebtedness that the shareholder has lent to the S corporation.
- The stock basis adjustment rules have already been discussed and under the ordering rules, losses are the last adjustment made to the tax basis at the end of the year. The losses are first applied against the stock basis and if the losses exceed that basis, the losses can still be claimed to the extent that the shareholder has any tax basis in indebtedness that the shareholder has lent to the corporation.

Loss Limitation Rules Applicable to S Corporation Shareholders

Passive Loss Rules

- If the shareholder is not deemed to "materially participate" in the activity being carried on by the S corporation, then the business of the S corporation may be characterized as a "passive activity." Material participation is defined in the Code and the Treasury Regulations and requires that the shareholder spend a certain amount of hours actively participating in the business.

- If the activity is deemed to be a passive activity with respect to the shareholder, then the losses generated by the activity will be deemed to be passive activity losses that can only be deducted against certain passive activity income. To the extent that the passive activity losses cannot be currently deducted, they are carried forward until the taxpayer has passive activity income. When the shareholder completely terminates his or her interest in the S corporation, then the suspended passive activity losses are deductible in full.

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Loss Limitation Rules Applicable to S Corporation Shareholders

At Risk Limitation

- A taxpayer can generally claim losses only to the extent that the taxpayer is deemed to be at risk with respect to the activity. The at risk limitation functions in similar ways to those for computing stock basis. The at risk rules measure a shareholder's investment in the S corporation's activity by the amount of capital that the shareholder has invested and by the amount of secured or unsecured debt that the shareholder extends to the activities of the S corporation. Generally, losses that exceed a shareholder's at risk amount are not currently deductible by the shareholder and are suspended until the shareholder has a sufficient at risk amount to cover the losses.

Thank You

S CORPORATION – LOSS UTILIZATION

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LOSS UTILIZATION

- **IRC §1366(d)(1)**: S Corp losses and deductions limited to extent of SH's basis in stock PLUS corporate debt to SH. **Basis determines**:
  - Deductibility of losses and deductions
  - Taxability of distributions
  - Gain/Loss on sale of stock
- Contribution to Capital raises Stock Basis
- **WATCH AT RISK REQUIREMENTS**

LOSS ORDERING

- First apply At-Risk Rules & Basis
- If Limited by § 465 – not a PAL
- If Insufficient Basis – not a PAL for year
- When Limitations Removed – PAL applies
- **Therefore, must pass Basis & At-Risk Tests**

RATABLE SHARE

- If part of S loss is disallowed § 1366(d)
- Ratable portion of each S loss item is disallowed
- Permitted to compute limitations on net loss
- Unless individual item taxed differently
- Ex. Part of Passive Rental Activity

HOW IS BASIS CREATED?

- Purchase / Gift / Inheritance
- Contribute cash or property (less liability assumed) **KEEP RECORDS & RETURNS**
- Accumulated and undistributed **income**
- Tax-exempt income
- Reduced by distributions losses and nondeductible expenses

INHERITANCE

- §1367(b)(4)(B)

- Reduction of FMV Basis

- By portion of value of stock attributable to IRD

EXAMPLE

- Inherit 20% S Corp.
- S Corp. fmv $1 million
- Including $500k cash A/R
- Basis = $100k

REG. 1.1367-1 BASIS

- **Stock Basis** purchase/ gift / inheritance
- Increase by K-1 income items & tax free
- Pro rata – per share per day
- Decrease **(not below 0)** k-1 losses & distributions
- Compute at end of year (or before disposition)

BASIS CONTINUED

- Contribute property – basis less liability assumed, **WATCH §357(c)**
- **EXAMPLE**: Property Basis $40,000, Value $100,000 and mortgage of $30,000 is contributed: **STOCK – BASIS $10,000**
- Special Estate Considerations – reduction for IRD type items
- Ordering Rules – will be discussed

BASIS DETERMINES

- Deductibility of losses and deductions
- Taxability of distributions
- Gain/Loss on sale of stock

LOSS UTILIZATION

- IRC §1366(d)(1)

- **LIMITS** use of S Corp losses and deductions to extent of shareholder's **basis in stock**

- **PLUS** Corporate debt to shareholder.

LOSSES - UTILIZATION

1. First §1366(d)(1) Stock Basis
2. Then reduces Basis in debt to Corp
3. Remainder carried forward

- **REMEMBER** – basis does not include guarantees or circular loans
- Back-to-Back – must be bona fide
- *See* §1.1366-2(a)(2)(i) & (iii),ex. 2

BASIS

- ***Barnes v. Comm*.**, 111 AFTR 2d 2013 (DC Cir)
- Affirmed Tax Court, **TCM 2012-80** – reduce basis even if fail to deduct the loss
- S SHs inadequate basis
- Unable to deduct losses – limited to basis
- Basis not increased by prior losses not claimed
- Taxpayer failed to deduct suspended losses
- Statute of limitations expired

LOSS UTILIZATION

- ***Gleason v. Commissioner***, TCM 2006-191 (9/11/06)
  - Taxpayer won as borrower on a $6m loan
  - IRS re-characterized loan properly made by taxpayer because loan payments paid by Corp and stock was pledged as collateral
- ***Kerzener****, TCM 2009-76*
  - **CIRCULAR LOAN** from p'ship to S SH to S corp did not create basis.
  - S Corp paid equivalent rent back to the p'ship.
  - Transaction **lacked economic substance**
  - **MERE CONDUIT** – No sufficient risk
  - Court distinguished Ruckriegel and Culnen
- ***Nathel***, 105 AFTR 2 ¶ 2010-927 (2nd Cir. 6/2/10)
  - Equity and debt are distinguishable
  - Contribution of equity increases basis of stock but does not restore loan basis
  - CONTRIBUTIONS TO CAPITAL ARE **NOT** INCOME!

NATHEL

- Attempted to restore or increase loan basis
- Corp. repaid shareholder loans with reduced basis (from losses)
- Recognized Ordinary Income on repayment of loan
- Capital contributions do not create exempt income (income increases loan basis)
- Supreme court denied cert.

Culnen, TCM 2000-139

- Distributions from profitable S to loss S added to basis > $3 Mil:
  i. amounts came out of S earnings,
  ii. always shown on books as loans to/from shareholder, and
  iii. all bank financing statements showed the loans as personal, not corporate.
- **IRS** permits Back to Back loans (bona fide)

BACK TO BACK LOANS

- **Prop. Reg. §1.1366-2**
- "Bona fide indebtedness"
- All facts & circumstances considered
- General tax principles
- ***MAGUIRE***, TCM 2012-160
    - Auto dealer and finance company
    - Finance A/R distributed then contributed

BONA FIDE DEBT

- Watch Second Class of Stock Rules
- Straight Debt Safe Harbor
- Reg. §1.1361-1(l)(5)

DEBT v. EQUITY

- Transfers to Corp generally equity, not loan
- Capital contribution
- **Corp's payment of personal expenses = dividends**
- Not repayment of loan
- No debtor/creditor indicia
- *ACM Environmental Services*, TCM 2012-335
- **Proper documentation missing**

NOT BONA FIDE DEBT

- No Bad Debt Deduction –***Herrera v. Comm'r***, 112 AFTR2d 2013-6858 (5th Cir.)
- LLC (partnership) Loans to related steel corp.
- No written promissory notes
- No definite maturity
- No repayment schedule
- No security – no payments

OPEN ACCOUNT DEBT INTRODUCTION

- ***Brooks v. Commissioner*** – TCM 2005-204 (August 25, 2005)

- **Final Regulations**

LOANS

- Assume Stock Basis $100
- If X $200 loss, shareholder deducts only $100
- §1366(d)(1) deductions limited to Basis
- **Basis can never be negative**
- So shareholder loans $100 to Corp on 12/31
- Stock Basis & Loan Basis is **$0**
- Later income first restores Loan Basis

OPEN ACCOUNT DEBT

- Shareholder loans/advances not evidenced by written instrument
- New Regulations – advances 10/20/08 and thereafter
- Limit $25,000 per Shareholder
- **EXAMPLE** – Each Sh. can have up to $25,000 of Open Account Debt

BE CAREFUL

- No Shareholder exceeds limit
- Keep records per Shareholder
- Not day/day – END OF **S** YEAR
- Unless debt disposed or Shareholder terminated

WHAT HAPPENS

- When $25,000 limit exceeded
- Debt at end of year treated **AS IF** evidenced by separate written agreement
- No longer Open Account Debt
- Debt existing on 10/20/2008 is not subject to new rules and is treated as a separate loan
- Identification issues exist

LOSSES – ORDERING RULES

- Losses first absorb Stock Basis
- Then reduce Debt Basis
- **NOT BELOW ZERO**
- Multiple indebtedness – Loss Allocated
- Based upon aggregate Basis
- Intricate record keeping required

RESTORATION

- Distinction between Stock & Debt Basis
- "Net Income" restores Debt Basis first
- "Net Increase" is §1367(a)(1) income items
- New contribution(s) - increase Stock Basis (*Nathel*)
- Computations generally determined at **end of the year**

COMPUTATION

- Advances and Repayments are netted
- At close of S Corp year
- Net Advance or Repayment is combined with Principal balance of Open Account Debt
- Carried to next year (unless > $25,000)
- IF > $25,000 – no longer Open Account Debt
- Treated as if separate debt.

EXAMPLE ONE

- A’s Stock Basis is $0
- 6/1/09 A loans S $16,000 (no note)
- 12/31/09 – Open Account Debt = $16,000

EXAMPLE TWO – 2009
STOCK BASIS $0

- A lends $16,000 6/1/09
- 12/31/09 Loss <$8,000>
- A's <u>BASIS</u> in Open Account Debt is $8,000
- Principal Loan amount remains $16,000

EXAMPLE THREE – 2010

- A Stock Basis = $0 Loan Basis = $8,000 (principal $16,000)
- 4/1/10 – S Repays to A $4,000
- 9/1/10 – A Advances $1,000 (net $3,000)
- 12/31/10 – Debt Principal $13,000
- Still open Account Debt

EXAMPLE THREE CONTINUED

- A **Ordinary Income** $1,500 (8/16 x $3,000 Net Repayment)
- <u>IF evidenced by note Capital Gain</u>
- Debt treated **“as if”** evidenced by note, tax effect not addressed
- 12/31/10 – Open Account Debt Principal $13,000
- Carried to 2011

EXAMPLE FOUR (ex. 3 FACTS)

- 2/1/11 – S Repays A $5,000
- 3/1/11 – A Advances $20,000
- Not evidenced by a written agreement
- 2011 Net Advance $15,000
- Debt $28,000 (> $25,000 – not Open Account Debt)
- Treated **as if** evidenced by a separate written agreement – **maintain records**

REPORTING REQUIREMENTS

- Must keep records per shareholder
- IF hold more than one indebtedness at close of year –
  - Basis is reduced proportionately to aggregate Basis
  - Net increase is applied to <u>first restore</u> debt basis before stock basis
  - First restore Basis of any debt which is repaid during year

WHO CARES?

- The IRS & the Treasury
- $25,000 limitation eliminates Year End Repayments
- Mixed blessing
- Gain on Repayment of Debt evidenced by notes is **CAPITAL GAIN**
- Repayment of Open Account Debt with reduced basis = **ORDINARY INCOME**

NATHEL

- Attempted to restore or increase loan basis
- Corp. repaid shareholder loans with reduced basis (from losses)
- Recognized Ordinary Income
- Capital contributions do not create exempt income (income increases loan basis)
- Supreme court denied cert.

PLANNING

- Reduce YE Balance < $25,000
- Use Note – Capital Gain
- Do Not Repay
- Identify Debt Repaid
- Contribute to Capital

SCOTT SINGER INSTALLATIONS INC. – TCM 2016-161

- IRS – payment of personal expenses **WAGES**
- TP Advanced $ to Corp.
- Corp. paid TP's expenses
- TP – Loan repayment not wages
- No Notes or Debt Acknowledgement

SHAREHOLDER LOAN SUFFICENT?

- Court Said Yes
- In years Co. was profitable
- In other years No!
- Look at all factors
- Need Debtor/Creditor Relationship

TCJA

- Suspended Losses
- FIFO Order
- Watch EBL Limitations
- Post 17 Losses
- Reduce QBI