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9.0 SHAREHOLDER BASIS

9.1 IMPORTANCE OF COMPUTING SHAREHOLDER BASIS

- To determine the amount of losses and deductions allowed to be recognized currently.
- To determine the taxability of distributions from the S corporation.
- To determine the taxability of debt repayments.
- To determine the gain (loss) on stock redemption/disposition.

Note: The examples used in Chapter 9 (Shareholder Basis) and Chapter 8 (Distributions/AAA) are simplified. They have not been computed on a per day, per share basis as in the Treas. Reg.' examples. If you have situations that have multiple stock purchase days, please be aware you need to compute the basis/AAA on a per day, per share basis.

9.2 SCOPING A SHAREHOLDER BASIS ISSUE

It is imperative that the corporate folder and all returns filed by the shareholder(s) be obtained before selecting the basis issue for an audit. With the exception of stock redemptions/dispositions, the basis issue is a timing difference issue.

Example A

Note: During scoping it may be difficult to locate flow-through losses (generated by S corporation) on each shareholder's tax return. It is because certain loss items may be limited by various limitations.

Schedule K-1 items should be traced to each shareholder's return. Recognized losses and deductions may have already been limited due to shareholder basis, at-risk, passive activity losses, capital loss, charitable contributions, and similar limitations.

Schedule K-1 charitable contribution	$1,000,000
Shareholder basis limitations applied	400,000
Federal AGI limitations applied	3,000

The S corporation generated a pass-through charitable contribution of $1,000,000. The shareholder recognized only $3,000 per Schedule A after applying the shareholder basis and federal AGI limitations.

Example B

Even with a beginning basis of zero, the shareholder is allowed to recognize losses/deductions equal to his/her current distributive income items.

Beginning shareholder basis	$0
Interest income per Schedule K-1	600,000
Ordinary loss per Schedule K-1	-1,000,000

The shareholder would report $600,000 interest income on Schedule B and is entitled to an offsetting loss of -$600,000 on Schedule E.

If the shareholder reported a loss in excess of -$600,000 on Schedule E, the maximum audit adjustment would be the amount in excess of the -$600,000.

9.3 INITIAL STOCK BASIS

Internal Revenue Code (IRC) §1367(a)(1)-(2) (R&TC §23800 and R&TC §23804) provides for adjustments to the basis of shareholder stock in an S corporation. It does not address initial stock basis. IRC §1371(a) (R&TC §23800 and R&TC §23806) -- Coordination with Subchapter C, remedies this problem by requiring application of subchapter C provisions when there are no provisions under subchapter S.

Initial stock basis is determined under the general basis rules beginning with IRC §§1011 and 1012. For your convenience, a list of general rules follows:

How Stock is Acquired	How Basis is Determined
Purchase	If the shares were purchased outright, initial basis is the cost of the shares.
S corporation capitalized	If the shares were received when the S corporation was capitalized under IRC §351, the basis in the stock is equal to the basis of the property transferred to the corporation, reduced by the amount of property received from the corporation, increased by gain recognized on the transfer, and decreased by any boot received (IRC §358).
Prior C corporation	Initial basis in S corporation stock is the basis in the C corporation stock at the time of conversion.
Gift	The recipient's basis in shares received by gift is generally the donor's basis (IRC §1015). Suspended passive activity losses can increase the basis of a gift (IRC §469(j)(6)).
Inheritance	The basis of inherited stock is its fair market value at the date of death, or, if elected, the alternate valuation date (IRC §1014).
Services rendered	Basis in stock received in exchange for services is measured by the stock's fair market value, rather than by the value of the services (Treas. Reg. §1.61-2(d)(2)(i)).

9.4 ITEMS AFFECTING SHAREHOLDER BASIS

The basis adjustment rules under IRC §1367 are similar to the partnership rules under IRC §705. However, while a partner has a unitary basis in his partnership interest, the adjustments to the basis of stock of an S corporation are applied on a separate share basis.

9.4.1 Pro-Rata Distributive Share Items That Increase Stock Basis

IRC §1367(a)(1)	Also Known As	Specific Income Items
(A) Items of income (including tax-exempt income), the separate treatment of which could affect the liability for tax of any shareholder.	Separately stated items	Rental income, real estate and other. Interest and dividend income. Royalties. Capital gains. Other portfolio income. IRC §1231 gain. Tax-exempt income. Other income. Cancellation of Indebtedness (COD) Income incurred on or before 12/31/02. See discussion below.
(B) Nonseparately computed income.	Nonseparately stated items	Schedule K-1: Ordinary income from trade or business activities.
(C) The excess of		

deductions for depletion over the basis of the property subject to depletion.		

Separately and nonseparately stated income items will adjust stock basis only if shareholders include them in gross income as reported on their individual income tax returns (if required to be reported). (IRC §1367(b)(1))

a. Tax-Exempt Income

The general rule of IRC §1367(b)(1) does not apply to income that is not required to be included in gross income, such as tax-exempt interest income.

b. IRC §108 COD Income

- Discharge of Indebtedness Occurring on or before December 31, 2001

The U.S. Supreme Court, reversing the 10th Circuit court, held in Gitlitz v. Commissioner, 2001-1 USTC 50, 147 that the S Corporation's excluded discharge of debt is an item of income that passes through to the shareholders pursuant to IRC §1366(a)(1)(A).

The cancellation of debt (COD) income increases the shareholder's stock basis before the tax attributes reduction takes place pursuant to IRC §108(b)(4)(A).

Previously, the Franchise Tax Board (FTB) took a position consistent with the 10th Circuit Court, which states that the S Corporation's COD income does not pass through to the shareholder and does not increase the shareholders basis. FTB has revised our position to conform to the U.S. Supreme Court decision to allow the S Corporation to pass the COD income to the shareholder and increase the shareholder's basis. The basis increase takes place at the time of the discharge (the year in which the COD income is incurred), and before the tax attributes reduction (the year following the discharge).

Treas. Reg. §1.1366-1(a)(2)(viii) was amended to specifically state that the COD income is not tax-exempt income. Nevertheless, the U.S. Supreme Court decision holds that S Corporation COD income is an item of income for pass through purposes per IRC §1366. Treas. Reg. §1.1366-1(a)(2)(viii) no longer has a bearing on the COD income issue.

In summary,

- The S corporation COD income is "an item of income" for pass through purposes.
- The S corporation COD income will pass through to the shareholders.
- The S corporation COD income will pass through to the shareholders in the year of the discharge, prior to the tax attributes reduction under IRC §108.

The Supreme Court has considered that the taxpayer will receive the "double windfall" benefit. (TP incurred no payout but received basis). The Supreme Court indicated that the double benefit realized by the taxpayer was required by the plain text of the statute.

- Discharge of Indebtedness Occurring after December 31, 2001

Congress passed a provision that reversed the U.S. Supreme court's decision in Gitlitz v. Commissioner, 2001-1 USTC 50, 147 and revised IRC §108. Now if an S Corporation has discharge of indebtedness income that is excluded from income it is not taken into account as an item of income by the shareholder and thus does not increase the basis of the shareholders stock in the S Corporation.

CA conformed to the federal change by way of AB 1122. The effective date of the state's conformity is for discharges of indebtedness occurring after December 31, 2001, in taxable years ending after that date.

9.4.2 Pro-Rata Distributive Share Items That Decrease Stock Basis

IRC §1367(a)(2)	Also Known As	Specific
(A) Distributions by the corporation that were not includible in the income of the shareholder by reason of IRC §1368.	Return of capital distributions	
(B) Items of loss or deduction, the separate treatment of which could affect the liability of any shareholder.	Separately stated items	Rental losses, real estate and other. Capital losses. Charitable contributions. Political contributions. Expense deductions for recovery property. Deductions related to portfolio income (loss). Other deductions. Note: Credits are not an item of loss or deduction.
(C) Nonseparately computed loss.	Nonseparately stated items	Schedule K-1: Ordinary loss from trade or business activities.
(D) Any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account.	Noncapital, nondeductible expenses	Illegal bribes, kickbacks, and other payments not deductible under IRC §162(c). Nondeductible portion of meals and entertainment expenses, under IRC §274. Income taxes attributable to the corporation's operations as a C

		corporation. Wages that are nondeductible because of targeted jobs tax credit. Research and development expenditures that are not deductible because of the R&D credit. Nondeductible fines and penalties, under IRC §162(f). Nondeductible interest expense, such as interest on a loan used to purchase tax-exempt securities, under IRC §265. Nondeductible life insurance premiums. Nondeductible franchise tax. Losses for which the deduction is disallowed under IRC §267(a)(1). The two-thirds portion of treble damages paid for violating antitrust laws not deductible under IRC §162. These include only those items for which no loss/deduction is allowable and do not include items the deduction for which is deferred to a later taxable year.
(E) The amount of the shareholder's deduction for depletion for any oil		

and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under IRC §613A(c)(11)(B).		

a. Charitable Contributions:

Charitable contributions decrease basis to the extent of the pass-through deduction, without reference to the contributed asset's basis. Shareholder basis is reduced by the fair market value of the asset contributed, regardless of any limitation on deductibility of the contribution applicable at either the S corporation or shareholder level. (IRC §§1367(a)(2) and 1366(a)(1)(A))

b. Life Insurance Premiums:

Life insurance premiums paid by a corporation are not deductible if the corporation is the beneficiary of the policy and may decrease shareholder basis as noncapital, nondeductible expenses. (R&TC §24424 and IRC §1367(a)(2)(D))

c. Loss/Deduction Amounts Used for Shareholder Basis v. Franchise Tax:

Amounts contained on Schedules K and K-1 may differ from amounts reported in the determination of the S corporation's franchise tax liability. Capital losses, charitable contributions, passive activity losses, etc. are limited at the S corporation level for purposes of applying the 1.5% tax. Schedules K and K-1, however, should reflect 100% of income, loss, and deduction items generated currently by the S corporation.

Example A

	S Corporation Return Recognized (1.5% Tax)	Schedule K
Capital Loss:		
Year 1 - Loss generated but limited	-$50,000	-$500,000
Year 2 - Carryover, limited	-150,000	0
Year 3 - Carryover, limited	-75,000	0
Year 4 - Carryover, recognized in full	-225,000	0
Total	-$500,000	-$500,000

In Year 1, Schedule K should reflect a separately stated capital loss of $500,000.

In Years 2-4, Schedule K should reflect no separately stated capital loss from the transaction generated in Year 1. If it does, the shareholder probably included the loss in his/her basis computation again. In this situation, you would have an audit adjustment to disallow any decreases to basis in excess of the $500,000 taken in Year 1.

9.4.3 Items Not Affecting Stock Basis

Transactions between the shareholder and S Corporation are not items that increase (decrease) basis. Such transactions include:

- Salary from the S Corporation
- Interest, rent, and royalty payments.
- Gain (loss) on the sale of property.
- Distributions from the S Corporation treated as gains or dividends.
- Expenses paid on behalf of the S corporation by the shareholder.
- Interest paid by the shareholder to the S corporation relating to debt-financed stock acquisitions.

9.5 SHAREHOLDER BASIS IN INDEBTEDNESS

IRC §1366(d)(1) provides that the aggregate amount of losses and deductions taken into account by a shareholder under IRC §1366(a) for any taxable year cannot exceed the sum of:

(A) The adjusted basis of the shareholder's stock in the subchapter S corporation, and
(B) The shareholder's adjusted basis of any indebtedness of the subchapter S corporation to the shareholder.

9.5.1 Concept of Indebtedness

While IRC §1366 requires that the debt of the corporation run directly to the shareholder, form is only one part of the analysis under IRC §1366. A shareholder must establish indebtedness of the S corporation to the shareholder. IRC §1366 does not specifically set forth what constitutes "the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder." However, the report of the Senate committee on Finance accompanying prior legislation indicates that the purpose of that section is to limit the amount of a subchapter S corporation's net operating loss that may be deducted by a shareholder to the "adjusted basis of the shareholder's investment in the corporation." (S. Rep. No. 1983, 85th Cong., 2d Sess. 220 (1958))

In applying the concept of indebtedness to be comparable with actual capital investment by S corporation shareholders, courts have consistently held that "indebtedness of the S corporation to the shareholder" is meant to suppose an actual economic outlay by the shareholder that finds a shareholder poorer in a material sense after the transaction than when the transaction began. (See 9.5.2 (d) for details.) The determination of whether there is an actual economic outlay by a shareholder such that the shareholder is poorer in a material sense depends on the facts and circumstances of each case.

9.5.2 Summary of Case Law

Case law supports different results based on whether the lender on the shareholder's note is a bank – an arms-length loan with a disinterested third party – or whether the shareholder has interjected himself as the middleman in several loan obligations between his controlled business entities.

a. Arm's Length Loans with Disinterested Third Parties and Shareholder Loan Guarantees:

Through a succession of cases, courts have developed a rule that a shareholder has no basis in debt for purposes of IRC §1366(d) where the shareholder merely guarantees an S corporation's debt or executes a surety agreement with respect to the corporation's debt. Only after the guarantor or surety performs on his contract of guaranty does the debtor's liability to the creditor become indebtedness to the guarantor.

- Rev. Rul. 70-50, 1970-1 CB 178

  An S corporation incurred net operating losses for two consecutive years and the shareholder's portion of the loss for the second year was greater than the adjusted basis of his stock in the corporation. In the third year, the corporation defaulted on a bank loan guaranteed by a shareholder. The shareholder paid the bank loan in satisfaction of his guarantee.
  Although the shareholder's guaranty of the corporation's indebtedness did not create an indebtedness of the corporation to the shareholder, when the shareholder later paid the corporation's creditor in satisfaction of his guaranty, the corporation became indebted to the shareholder under the doctrine of subrogation.

- Rev. Rul. 71-288, 1971-2 CB 319

Clarified Rev. Rul. 70-50 to provide that the indebtedness of the corporation to the shareholder arising in the third year upon payment by the shareholder under his guaranty did not relate back to the second year, and would not entitle the shareholder to deduct any portion of the corporation's losses in the second year in excess of the adjusted basis of his stock in that year.

- Rev. Rul. 75-144, 1975-1 CB 277

  The facts are the same as in Rev. Rul. 70-50, except that instead of actually paying money to the bank in satisfaction of his guaranty, the shareholder, in the third year, executed his own promissory note for the full amount due and substituted it for the note of the corporation. The bank accepted the note in satisfaction of the guaranty and relieved the corporation of its liability on the old note. The shareholder made no payment on his own note until the fourth year.

  The execution of a note by a shareholder, together with the acceptance of the note by a bank, under the circumstances described above, cause the indebtedness of the corporation to accrue to the shareholder, and created a basis in the indebtedness for purposes of computing his share of net operating losses of the corporation, if any, in the third year, or any subsequent taxable year of the corporation.

- Raynor v. Commissioner, 50 TC 762 (1968)

  A taxpayer owned stock in three S corporations and made various loans to the corporations along with other shareholders. In addition to these loans from shareholders, the corporation received loans from third parties that were co-signed or guaranteed by the shareholders, and the shareholders executed notes to one of the third parties as additional security for the corporation's debt.

  The court stated that the fact that the shareholders may be primarily liable on indebtedness of a corporation to a third party does not mean that this indebtedness is "indebtedness of the corporation to the shareholder" within the meaning of IRC §1374(c)(2)(B).

No form of indirect borrowing, may it be a guaranty, surety, accommodation or co making, or otherwise give rise to indebtedness (emphasis added). Thus the shareholders were not allowed debt basis for the amount of the loans they co signed/guaranteed.

A long succession of cases follows Raynor.

- Duke vs. Commissioner, 35 TCM 229, TC Memo 1976-50

  Notes were obtained by the corporation, signed by the officer-shareholders of the corporation, both in their capacities as officers and as co makers. The bank required the officer-shareholders to bind themselves personally, along with their companies on small corporate loans. The bank knew the loan exceeded the corporation's net worth.

  The corporation reflected the loan as a loan from the bank in its books and records. The equity accounts did not reflect loans from the officers/shareholders/co-makers. The corporation made all principal and interest payments on the loans.

  The court held that "the evidence is unmistakably clear that, even though petitioner signed the notes as co maker, he was merely a guarantor thereof…SEA (corporation) received proceeds of the loans and the notes were always treated as SEA's obligations. None of the proceeds were treated as capital contributions to SEA, and all payments on the notes were made by SEA." Thus, the court held that the shareholders were guarantors of the loan and did not have debt basis.

- Harrington vs. United States, (D. Del, 1985) 605 F. Supp. 53

  The taxpayers' basis in their stock of the corporation at the end of the 1980 tax year was $2.50, but they claimed that they had a pro rata share of indebtedness to shareholders of $5,000. During 1980, the taxpayers and four other shareholders executed a $200,000 note to secure a credit line with a bank. The proceeds were to be used for equipment for the corporation, which was added as a signatory to the note at the insistence of the bank to enable the bank to get a lien on the equipment. The wives of the shareholders were also added to the note at the insistence of the bank. The taxpayers argued that since they provided the collateral and were co-makers on the note, they substantively received the loan and then made a separate loan to the corporation. The court indicated that Raynor would apply only if it was first determined that there was no economic outlay. Therefore, because the shareholders had made no loan repayments, the court found that no economic outlay had been made and applied the reasoning in Raynor.

Absent actual economic outlay, indirect borrowing cannot give a shareholder basis in the debt. Guarantors, sureties, accommodation parties, co-makers etc. are indirect borrowers. An accommodation party is one who signs the instrument in any capacity for the purpose of lending his name to another party to it. If a shareholder is an accommodation party, the shareholder is an indirect borrower. If there is no economic outlay, then the shareholder is not entitled to any basis in the debt. (See also Reser v. Commissioner (1995) TC Memo 1995-572 (70 TCM 1472); and Grojean v. Commissioner (1999) TC Memo 1999-425 (78 TCM (CCH) 1249))

- Gilday v. Commissioner, TC Memo 1982-242

Shareholders of an S corporation gave their personal notes to a bank in cancellation of the corporation's note. (The corporation's notes were cancelled.) The substitution of the shareholder's note for that of the corporation created valid debt from the corporation to the shareholder and thus increased the shareholder's basis in the stock.

- Leavitt, Estate of Daniel v. Commissioner, 875 F. 2d 420

The Court of Appeals for the Fourth Circuit, affirming the Tax Court, refused to find that the taxpayers had bases in loans from a bank to an S corporation where the taxpayer had personally guaranteed those loans. At the time of the loan, the corporation's liabilities exceeded its assets, it had virtually no cash flow, and it offered no assets as collateral. The bank would not have made the loan without the shareholder guaranties. The corporation's returns and financial statements reflected that the loan was from the shareholders. The court focused on how the parties actually treated the loan, not on how they nominally reported it on their returns and financial statements. The corporation paid the principal and interest to the bank, and neither the corporation nor the shareholder treated the corporate payments on the loan as corporate payments to the shareholders. The taxpayers argued that the loan was in substance a loan to them and then a subsequent loan to the corporation.

The court found the taxpayers' position inconsistent with the true form of the transaction and concluded that there had been no economic outlay, as the shareholders had not been called upon to make payment on the guaranty.

- Harris v. United States, (5th Cir. 1990) 902 F.2d 439

  The taxpayers formed Harmar, an S corporation, which was initially capitalized by its two shareholders with $1,000 and a loan for $475,000. Harmar received a $700,000 loan from Hibernia National Bank to purchase a movie theater. To secure the loan with Hibernia, Harmar executed two notes in the amount of $350,000. Assets of the first shareholder secured one, while the second was secured by a mortgage on the theater. The mortgage also secured any other debt of Harmar to Hibernia. Each shareholder also executed personal guaranties of Harmar's debt. The Commissioner disallowed a loss claimed by the shareholders as it exceeded their bases. The taxpayers sought to have the court ignore the form of the transaction, namely, that the $700,000 loan was to them and that they subsequently contributed such amounts to Harmar's account. This allegation was supported by a bank officer's testimony that the bank looked primarily to the shareholders for repayment.

  Harmar received the interest notices, paid all principal payments, and deducted those interest payments on its income tax returns. Harmar's books and records reflected that the loan was not made by Hibernia until 1986, 4 years after the year in question, when it was reflected as being made by the taxpayers. Harmar's 1982 return showed no loan repayments to the shareholders, which it would have done if the loan had been one from the taxpayers to Harmar. The loan made by Hibernia was earmarked by Hibernia for a specific use by Harmar. Finally, the return indicated a $2,000 capital investment and a $68,000 loan from the taxpayers, which fell far short of the claimed $700,000 loan. The court concluded that the return was wholly inconsistent with the position of the taxpayers and, refusing to recast the bank loan to Harmar as being substantively from the bank to the shareholders to Harmar, found that no economic outlay had been made.

- Nigh, Charles v. Commissioner, TC Memo 1990-349

The shareholders of a corporation signed two notes to a bank as co makers. The corporation's assets were collateral on the loan. The bank had the right to go against the shareholders before repossessing the collateral. During some years the shareholders personally contributed money to the corporation to pay the indebtedness each month.

The court stated: "a shareholder's guarantee of a loan to a subchapter S corporation may not be treated as an equity investment in the corporation absent an economic outlay by the shareholder. In the instant case, petitioners were co-makers rather than guarantors, but this does not change our analysis. See Estate of Leavitt v. Commissioner, (1988) 90 TC 206, 212-218, aff'd (4th Cir. 1989) 875 F.2d 420. Accordingly, we reject petitioner's argument" (that as co makers of the loans they had in substance borrowed funds and made contributions to the corporation's capital that increased their basis).

The parties agreed that the petitioners are entitled to basis for the funds they personally contributed to the corporation to pay the loans.

- Reser, Don C. v. Commissioner, (1995) TC Memo 1995-572

The taxpayers formed Don C. Reser, P.C. (DRPC), an S corporation, which was initially capitalized by its sole shareholder, Don Reser, with $6,000. During 1985, Don Reser and DRPC together obtained a line of credit from North Frost Bank. Both Reser and DRPC submitted financial statements to Frost Bank. The credit line was documented by 14 promissory notes, each payable 90 days after execution. They were dated October 7, 1985, through January 10, 1989. The final note, dated January 10, 1989, states a cumulative principal loan balance of $467,508.54. Don Reser and DRPC were jointly and severally liable on the notes for repayment of the loan.

The loan was not collateralized with any property of Don Reser or DRPC. On November 16, 1986, a guaranty agreement was executed by Don Reser, DRPC, and Don Test, under which Don Test would guarantee the loan for a fee of $14,998.50 for each 90-day period that the guaranty was outstanding. Don Reser and DRPC were jointly and severally liable to Don Test for payment of the fee. Frost Bank would have granted the line of credit to either Don Reser or DRPC individually, but to neither without Don Test's guaranty. Don Test was not a shareholder or otherwise related to the corporation.
The line of credit was used both as a source of operating capital for DRPC and for Don Reser personally. The credit line funds went directly into DRPC's account, and any proceeds petitioner used were drawn out of DRPC. Don Reser apparently did not make any repayments on the notes to Frost Bank; DRPC may have made the only principal payments on the notes. In 1989, pursuant to the guaranty agreement, Don Test apparently paid the balance of the notes.

In this case, there is one factor different than in Harrington, and that is rather than a shareholder making a personal guaranty, as in Harrington, here there was a third-party guarantor, Don Test, who was actually paid by the corporation. The court found this much stronger evidence that the corporation was the primary obligor, and that Don Reser was the accommodation party and not entitled to basis for any amount of the debt with Frost Bank.

- Salem, Richard v. Commissioner, TC Memo 1998-63

An accountant advised shareholders of an S corporation that, "The safest course of action and the one we recommend is to restructure the loans so that you are a co maker rather than a guarantor. In this way, you can clearly demonstrate that you have basis in the losses which flow through on your individual income tax return and take full advantage of the concomitant tax benefits."

Shareholders executed replacement notes, which were signed by the shareholder as vice president on behalf of the corporation and the shareholders as individuals. The security on the replacement notes remained the same. The corporation made all payments on the loans.

The corporation return reflects loans payable to shareholders while its ledger for the year reflects loans payable to the bank. There were never any loan documents executed among the corporation and the shareholders evidencing loans from the shareholders to the corporation.

The court held that, in order to qualify for indebtedness under IRC §1366(d), the indebtedness of the S corporation to the shareholder must have arisen as a result of an actual economic outlay by the shareholder, Harris v. United States, 902 F. 2d 439, 443 (5th Cir.); Estate of Leavitt v. Commissioner, 875 F. 2d 420 (4th Cir 1989). In Raynor, the court held that no form of indirect borrowing, be it guaranty, surety, accommodation, or co making gives rise to indebtedness from an S corporation to the shareholders unless and until the shareholders pay part or all of the indebtedness, Raynor v. Commissioner, 50 TC 762 (1968).

Thus the court held that a shareholder signing as a co maker of a note payable to a bank does not give rise to debt basis. The fact that the shareholders were co makers rather than guarantors did not change the analysis, Nigh v. Commissioner, TC Memo, 1990-349.

Other cases which discuss arm's length loans with disinterested third parties and/or shareholder loan guarantees are:

- Blum, Peter v. Commissioner, (1972) 59 TC 436
- Perry, William v. Commissioner, (1966) 47 TC 159
- Thompson, Mark v. Commissioner, TC Memo 1977-35
- Brown, J.W. v. Commissioner, TC Memo 1979-220
- Brown, Frederick v. Commissioner, TC Memo (6th Cir. 1983) 706 F.2d 755
- Bader, Lewis v. Commissioner, TC Memo 1987-30

Special Note: Selfe, Edward M. and Jane B. v. U.S., 86-1 USTC 9115 (11th Cir.)

In December 1985, the Eleventh Circuit reviewed a district court decision, Selfe, which resulted in the allowance of shareholder loan guarantees as qualified indebtedness even though the shareholder had never been called upon to satisfy the debt guarantee on behalf of the corporation. This case prompted extensive litigation from shareholders who guaranteed the loans of their S corporations. The facts in Selfe were similar to those in many of the cases that taxpayers had argued unsuccessfully.

Mr. Selfe, who represented himself before the Eleventh Circuit, cited an old case that did not involve an S corporation. In Plantation Patterns, Inc. v. Commissioner, on which Mr. Selfe relied, the IRS had prevailed in reclassifying debt as equity. [Plantation Patterns, Inc. v. Commissioner, 72-2 USTC 9494 (5th Cir.), cert. denied]. There have been numerous cases in which debt from a C corporation has been reclassified as equity, but these cases involve loans from shareholders to the corporation. The Plantation Patterns case went one step further than the usual debt versus equity case. In it the IRS reclassified a debt from a third-party lender to the corporation as if the debt were a loan from the lender to the shareholder, followed by a contribution to the corporation's capital by the shareholder.

In the Plantation Patterns case, in which the IRS prevailed, three of the apparently most important aspects were as follows:

- The corporation was extremely thinly capitalized.
- The shareholder who guaranteed the loan had substantial assets.
- The IRS secured a deposition from the loan officer that the lender was looking primarily to the shareholder, rather than to the corporation, for repayment.

Selfe was able to establish that his facts were practically identical to those in Plantation Patterns. His wife, Jane Selfe, was the sole shareholder. The corporation was thinly capitalized, and Jane had substantial assets. The Selfe's secured a deposition from the lending officer that the bank was looking primarily to Mrs. Selfe, rather than to the corporation, for repayment of the loan. The Court looked to substance rather than form and treated the loan as equity contributions, in accordance with the precedent set in Plantation Patterns. Mrs. Selfe was allowed to deduct her loss. Shortly after the Selfe decision was published, taxpayers began to litigate the issue. To date, however, no courts, other than the Eleventh Circuit, have been willing to follow the Selfe decision.

One of the first cases heard by the Tax Court after Selfe was Estate of Leavitt v. Commissioner [Leavitt, Estate of Daniel, 90 TC 206 (1988)], which the Tax

Court could easily have rejected as being entirely different from Selfe. There were several shareholders involved, and the facts were quite different. The Tax Court went much farther, however. It stated its disagreement with the Eleventh Circuit decision in Selfe, holding that the Plantation Patterns doctrine was inappropriate for S corporations. It refused to accept a shareholder guarantee as the economic outlay necessary to create basis. One concurring opinion distinguished Leavitt from Selfe because the corporation in Leavitt had seven shareholders, each of whom claimed basis from guarantee.

The Selfe opinion has stood alone up to this point. The Tax Court and several circuits disagree with the reasoning set forth by the 11th Circuit. The reasoning in Selfe should not be followed, even though taxpayers may cite this case to support their positions.

The auditor should be extremely cautious to identify cases using arguments presented in Selfe and Plantation Patterns. For instance, in James A. Lane, Bankrupt v. United States, 742 F. 2d 1311 (11th Circuit), the court determined that the amounts advanced to the S corporations by the shareholder did not constitute debt, but were equity in the corporations. The bad debt deductions taken by the shareholder were disallowed due to the determination that the advances from the shareholder did not constitute a loan (debt) but were contributions to capital (equity) and, therefore, not deductible. The court cited Plantation Patterns, along with similar cases to support it’s holding.

Not only are taxpayers citing Selfe to support the inclusion of debt guarantees as qualified indebtedness, but are citing it as the “substantial authority” exception to the imposition of the accuracy-related penalty. Again, the auditor must use extreme caution in this situation. The Selfe decision was published in 1985. The Leavitt decision, which clearly stated the inappropriate reasoning presented in Selfe, was published in 1988. Several cases followed, none of which were decided in the taxpayer’s favor with the exception of the Eleventh Circuit. The taxpayer’s use of this case as “substantial authority” should be evaluated as follows: (1) what is the audit year in question and how far removed is it from the Leavitt decision in 1988, (2) how many published court decisions cited the Selfe decision as inappropriate for S corporations, (3) when did the tax services begin discussing the ramifications of using this case as citable authority, (4) have there been any federal cases which upheld the assessment of the penalty when the taxpayer cited Selfe, etc.

b. Related Party Loans - Restructuring After the Fact:

The Tax Court's opinion in Underwood v. Commissioner, 63 TC 468 which was followed by several cases with similar fact patterns, held that there was no actual economic outlay because the debt did not come directly from the shareholders. A sample fact pattern found in these cases involved loans from one wholly owned or controlled corporation to another wholly owned or controlled corporation (an S corporation) of a taxpayer. The S corporation suffers a loss during the year at issue. Near the end of the year, the shareholder(s) restructure the entity level loans so that the debt runs from the related loss corporation to the shareholder.

Case	**Type of Restructure**
Underwood v. Commissioner, 63 TC 468	Substitution of notes
Private Letter Ruling 9403003, September 29,1993 (not citable)	Substitution of notes
Wilson v. Commissioner, TC Memo 1991-544	Distribution of note
Shebester v. Commissioner, TC Memo 1987-246	Journal entries
Griffith v. Commissioner, TC Memo 1988-445	Journal entries
Burnstein, Sanford v. Commissioner, TC Memo 1984-74	Journal entries

Often, the entire transaction prevents any loss from actually being suffered by the shareholder. When shareholders put themselves between their controlled S corporations, it is not clear that taxpayers will ever make demand upon themselves for payment. Therefore, in these situations, the Underwood line of cases follows the rationale in the guarantee line of cases and, unless there is actual payment, there is no economic outlay and the shareholder has not made the kind of investment required in order to realize additional losses pursuant to IRC §1366(d).

c. Related Party Loans - Original Structure:

In the previous section, the related party loans involved restructuring after the fact to transfer basis from a profitable corporation to a loss corporation. But what if the series of transactions were initially structured in a manner that cash and/or property was transferred from a related profitable entity into the S corporation via the shareholders? There is little guidance from case law in this area.

The most important aspects of examining such a situation is to obtain all facts relevant to the series of transactions. It is recommended that the auditor obtain the following documents (this list is not intended to be all-inclusive):

- Loan documents from the shareholder to the S corporation.
- Journal entries booking the loan(s) from the shareholder.
- Canceled checks from the shareholder's account into the S corporation.
- Loan amortization schedules between the S corporation and shareholder.
- Journal entries reflecting principal and interest repayments.
- Canceled checks for principal and interest payments. Identify the shareholder's source of funds for financing the loan(s) to the corporation – for example (a) analyze whether the shareholder had the economic wherewithal to finance the loan from personal funds, (b) determine if the shareholder holds interest in other entities from which funds could have been obtained, (c) examine the shareholder's bank statements to determine whether a large deposit was made prior to the check date and trace its origin, etc.
- If the funds were obtained from a related entity, obtain copies of the journal entries booking the transaction from the related entity to the shareholder and all relevant supporting documentation.
- If the funds were obtained through a lending institution, identify the primary obligor and the ownership of assets guaranteeing the loan.

Note: Only request information that is reasonable and relevant to the audit.

In two recent memorandum decisions, the Tax Court found that under the facts and circumstances of the particular case, the back-to-back loan arrangement yielded a sufficient economic outlay to allow an increase in the shareholder's S corporations basis for purposes of the IRC §1366(d)(1) limitation. Therefore, full factual development including obtaining all relevant documents, even if they are not contemporaneous, and conducting interviews with any potential witnesses is critical to the final outcome of a back-to-back loan case. (See Culnen v. Commissioner (2000) TC Memo 2000-139 [79 TCM 1933]; and Yates v. Commissioner (Oct. 11, 2001) TC Memo 2001-280.)

In Culnen v. Commissioner (2000) TC Memo 2000-139 [79 TCM 1933], the Tax Court held that the taxpayer/shareholder had made an economic outlay in that money deemed to have been loaned to him from another wholly owned S corporation was in turn deemed to have been loaned by him to his majority owned cash-strapped S Corporation. The court found that the funds provided to the S corporation comprised an economic outlay by the taxpayer and the taxpayer was therefore eligible for basis in the deemed loan. In Culnen v. Commissioner (2000), supra, the Tax Court rejected the government's argument that as a matter of law, "The fact that all payments to Wedgewood Associates, Inc. came directly from Culnen and Hamilton, precludes petitioner from claiming those amounts as his basis in Wedgewood and thus, the Schedule E losses."

The Tax Court then stated in pertinent part:

"If respondent is suggesting that the question of whether Culnen & Hamilton lent those amounts to petitioner is irrelevant since, as a matter of law, direct payments by Culnen & Hamilton to Wedgewood establish Culnen & Hamilton's status as the investor in Wedgewood, he is wrong. In Hitchins v. Commissioner, 103 TC 711 (1994), in explaining the statutory requirement that the indebtedness of the S corporation must run directly to the shareholder, we made it clear that an indebtedness to an entity with pass-through characteristics that has advanced the funds to the S corporation and is closely related to the taxpayer does not satisfy the statutory requirement. See id. at 715. We did not say, however, that the fact that the borrowed funds originate with the closely related entity precludes the indebtedness of the S corporation from running directly to the shareholder. Certainly, where there is a close relationship among the S corporation, the taxpayer, and the related entity, we will scrutinize the relationships established with respect to the transfer of funds to ensure that those relationships comport with the statutory requirement."

Relying on Culnen v. Commissioner (2000), supra, and without analysis or explanation, the Tax Court in Yates v. Commissioner (Oct. 11, 2001) TC Memo 2001-280 reached a similar result for apparently the same reasoning. Because of the decision made in Culnen, auditors must obtain all the evidence to determine whether the loan from the profitable related entity is a bona-fide loan. Although not conclusive, evidence useful to make such determination is as follows:

- Loan agreement
- Note with stated rate of interest and a payment schedule
- Journal entries booked for the loan
- Journal entries booked for interest payments
- Canceled checks for payments made on the loan
- Canceled checks for interest payments

Because this type of loan is a closely related party transaction, the transaction must be held to a higher level of scrutiny than the normal third-party transactions.

d. Actual Economic Outlay

Introduction:

IRC §1366(a) provides that an S corporation shareholder may deduct his pro rata share of the S corporation's net operating loss. However, IRC §1366(d)(1) provides that the deduction is limited to the shareholder's adjusted basis of the corporation's stock and the adjusted basis of any indebtedness of the corporation to the shareholder.

The phrase "adjusted basis of any indebtedness of the corporation to the shareholder" appears straightforward at first glance. That is, the shareholder can have debt basis only for those loans made directly from the shareholder to the S corporation.

Observation:

Any loans made between two entities do not qualify as indebtedness of the corporation to the shareholder, and those loans are not included in the shareholders basis (IRC §1366(d)(1)). Also see Frankel v Commissioner 61 TC 343 (loans from partnership to S corporation), Prashker v Commissioner 59 TC 172 (loan from estate to S corporation), and Burnstein et al v. Commissioner TC Memo 1984-74 (loans between two S corporations).

The Issue:

The "adjusted basis of any indebtedness of the corporation to the shareholder" cannot be determined merely by looking to whether there are "notes" between the shareholder and the corporation. The issue turns on whether the shareholder made an "actual economic outlay," and "directly incurred the indebtedness."

In order to determine whether the taxpayer made an actual economic outlay, the particular facts and circumstances of the case should be developed. Questions to the shareholder/representative should be tailored to obtain relevant information.

- Information as to where the shareholder obtained the funds to "loan" to the S corporation.
- Bank statements of the S corporation will show any deposits made by the shareholder.
- Shareholder's bank statements will show where cash advance(s) were made to the S corporation.
- On the shareholder's bank statement; look for deposits from other sources that are similar in amount to the "cash advances" to the S corporation. Any large deposits require further inquiry.
- If there are deposits in the shareholder's account from a related entity, pull the related entity's tax returns.

Once all the facts and circumstances of the particular case are developed, the next step is to determine whether the entire transaction qualifies as an "actual economic outlay."

The following court cases are summarized to demonstrate what may and may not constitute an "actual economic outlay." Please note that this is just a starting point and should not replace any research performed by the auditor.

Court Cases - Factors Considered in Finding Actual Economic Outlay

- Actual Payment
  Generally, an economic outlay exists when a shareholder lends his own cash or property to his S corporation. In this situation, there would be an actual payment to the S corporation that would leave the taxpayer poorer in a material sense.

  "Before any deduction is allowable there must have occurred some transaction which when fully consummated left the taxpayer poorer in a material sense." Perry v. Commissioner, 54 TC 1293 aff'd [71-2 USTC ¶9502].

- Borrowed Funds

"This, of course, does not rule out the possibility that a shareholder could borrow the money personally and then loan the money to the corporation. In that event the corporation's debt would run directly to the shareholder" (Prashker v. Commissioner [59 TC 172]). For the shareholder to borrow the money "personally", "The involvement of an independent third party lender was critical to the result because there is no question that a lender such as a bank intends to force repayment, truly placing the shareholder's money at risk." Bergman v. United States (8th Cir. 1999) 174 F.3d 928

- Loan Restructuring (back to back loans)

It is also possible for a loan made as part of a loan restructuring to create additional basis for the shareholder. For example, in Gilday v Commissioner, [43 TCM 1295], basis is created when a shareholder, who had previously only guaranteed a loan to an S corporation (not considered as part of basis), borrowed funds in an arm's length transaction from a bank and then loaned the borrowed funds to the corporation.

However, not all loan restructuring transactions result in an "actual economic outlay." In Underwood v. Commissioner [76-2 USTC ¶9557], loans were originally between a C corporation and an S corporation. After the restructuring of the debt, the loan went from the C Corporation to the shareholders and then from the shareholders to the S corporation. The court noted:

"In the transaction at issue in this case, the taxpayers in 1967 merely exchanged demand notes between themselves and their wholly owned corporations; they advanced no funds to either Lubbock or Albuquerque. Neither at the time of the transaction, nor at any other time prior to or during 1969 was it clear that the taxpayers would ever make a demand upon themselves, through Lubbock, (the profitable corporation) for payment of their note. Hence, as in the guaranty situation, until they actually paid their debt to Lubbock in 1970 the taxpayers had made no additional investment in Albuquerque (the unprofitable corporation) that would increase their adjusted basis in an indebtedness of Albuquerque to them." (5th Cir. 1976) 535 F.2d 309.

In footnote #2 of this case, the court noted the distinction between obtaining funds from a bank, an outsider that stood ready to enforce the obligation, and that of related parties where it is not clear that a demand for payment would ever be made. In footnote #3, the government admits that when the shareholders make payment on the first note, the taxpayers increased their basis in the S corporation for the other note. Also see Wilson v Commissioner, [TC Memo 1991-544]; LeRoy Griffith v. Commissioner [TC Memo 1988-445]; and Bergman v. United States (8th Cir. 1999) 174 F.3d 928.

- Borrowed Funds Contributed to S Corporation

  In JH Harris and William J Martin v. United States (5th Cir. 1990) 902 F.2d 439, the loan was originally between the S corporation and the bank. The transaction was restructured to be a loan to the shareholders who then "contributed" the borrowed funds to the S corporation. The court denied the increase to debt basis because the documentation indicated that the form chosen and followed at all times was a loan from the bank to the S corporation. The taxpayer's testimony was contradictory to the evidence and unambiguous documentation presented. All transactions were directly between the bank and the corporation.

  In Silverstein v United States (E.D.La. 1972) 349 F.Supp 527, shareholders of an S corporation "contributed" a note to their S corporation at year-end in order to increase their bases in the S corporation so as to take advantage of the net operating loss of the corporation. The court denied an increase in basis noting that there was no "actual economic outlay." "The taxpayers' advisers, solely to minimize their client's tax liability, designed an elaborate form having neither business purpose nor economic substance." No payments were made on the principal of the note and minimal payments were made for interest.

- Distributions From One Entity and Loaned to the S Corporation

  In Shebester v. Commissioner (TC Memo 1987-246), the loans were originally between the two S corporations—one profitable and one not profitable. After the restructuring, the profitable corporation made a "distribution" to the shareholder; and the shareholder in turn "loaned" it to the unprofitable corporation. The shareholder included the distribution on his tax return as income. The court was not persuaded with the taxpayer's claim that the transaction was intended to be distributions as the structure was between the two entities. As for the "loan", the court found that there was no actual economic outlay. The court noted:

  "Although the entries in Hennessey's book [profitable corporation] technically reduced petitioner's book equity, such entries could not, absent liquidation of Hennessey, leave petitioner poorer in a material sense.

  Moreover, because petitioner had complete control over when and under what circumstances Hennessey would liquidate, and because the record is devoid of any evidence suggesting that petitioner would cause Hennessey to liquidate in the foreseeable future, we conclude that it was unlikely that the taxpayer would ever make an economic outlay in payment of A & L's (the unprofitable corporation) debt."

  Distributed loans and then the "loan" to the S corporation were also seen in Wilson v Commissioner (TC Memo 1991-544).

- Bona Fide Loan/At Risk

  In Bhatia et ux. v. Commissioner (TC Memo 1996-429), the court noted that the close relationship between the shareholder and his closely held

entities need not necessarily be fatal to the "actual economic outlay" issue so long as the "other" elements are present which clearly establish the bona fides of the transactions and their economic impact. In this court case, there was no evidence in respect of the actual existence of indebtedness of the corporations, or of the amounts or terms of that indebtedness as to interest or time of repayment, or of the taxpayer's basis in the S corporation before or after the transaction. Therefore, it was found that there was no actual economic outlay.
Other court cases have also emphasized that a shareholder's "loan" to his or her S corporation would not create basis for the shareholder when it is not clear their money is in fact at risk. See Brown v. Commissioner (6th Cir. 1983) 706 F.2d 755 and Hafiz v. Commissioner (75 TCM 1982)(1998).

- Transfers of Funds Between Entities

After many court cases denying debt basis to shareholders, shareholders are structuring the transaction from the onset to be "loans" from one entity to the shareholder and then loans from the shareholder to the S corporation. Yet, the funds are transferred directly between the two entities. In this situation, the underlying documents must be examined to determine the true nature of the transaction.

In Bolding v. Commissioner (5th Cir. 1997) 117 F.3d 270, TC Memo 1995-326 reversed, even though the bank transferred the funds directly to the S corporation, the true nature of the transaction was a loan from the bank to the shareholder and then a loan from the shareholder to the S corporation. The taxpayer was found to have made an actual economic outlay.

Payments directly between a bank and the S corporation have also been seen in Gilday v. Commissioner (43 TCM 1295). In footnote #8 the court points out that the payments were made directly between the S corporation and the bank. The court noted that to pay the shareholders and have the shareholders pay the bank would seem to be the utilization of fruitless steps.

- Debt Converted to "Equity"

To overcome the “actual economic outlay” test, shareholders receive a “distribution” from one related entity and then “contribute” it to their S corporation.

While there are no court cases specifically addressing these particular facts and circumstances, in Underwood v. Commissioner (5th Cir. 1976) 535 F.2d 309, the court applied the actual economic outlay theory to “investments” as follows:

The report of the Senate Committee on Finance accompanying the Subchapter S legislation indicates that the purpose of the section is to limit the amount of a Subchapter S corporation’s net operating loss that may be deducted by a shareholder to the “adjusted basis of the shareholder’s investment in the corporation.” (citation omitted.) Construing this language of the committee report in Perry v. Commissioner (1976) 54 TC 1293, affd. in unpub. Opin. (8th Cir. 1971), the Tax Court said “It appears to us that, given its most familiar meaning, the use of the word “investment” reveals an intent, on the part of the committee, to limit the applicability to the actual economic outlay of the shareholder in question.

The rule, which we reach by this interpretation, is no more than a restatement of the well-settled maxim that requires that “Before any deduction is allowable there must have occurred some transaction which when fully consummated left the taxpayer poorer in a material sense.”

Thus, it appears that whether the transaction is structured as a contribution or a “loan”, the basic test is whether the taxpayer is “poorer” in a material sense after the transaction than before the transaction.

e. Court Decisions on Miscellaneous Qualifying/Nonqualifying Indebtedness

- Partnership Indebtedness

Rev. Rul. 69-125, 1969-1 CB 207: Partnership loans to an S corporation are not debts owed directly to the shareholder and thus do not provide basis when the partnership is controlled by the corporation's shareholder.

Allen, Edward v. Commissioner, (1988) TC Memo 1988-166: In order to be considered part of the basis, the indebtedness must run directly from the corporation to the shareholder.

Frankel, E.J. v. Commissioner (1973) 61 TC 343: A loan from the partnership to the S corporation did not give the shareholder/partner debt basis.

- Common Control of Two S Corporations - Basis Cannot be Combined

Meissner, Douglas v. Commissioner, TC Memo 1995-191: Taxpayer, the sole shareholder of two S corporations, asserted that the loans from one to the other should be attributed to him due to the mere fact that he is the sole shareholder of both. The court held that the taxpayer could not ignore the corporate form in which he chose to do business – as two separate S corporations. The loans made to Corporation 1 cannot be attributed to Corporation 2 for purposes of recognizing net operating losses from Corporation 2.

- Shareholder and S Corporation Are Co-Makers or Jointly Liable on Note

Nigh, Charles v. Commissioner, TC Memo 1990-349, Duke, Albert D. v. Commissioner, TC Memo 1976-50: The Tax Court ruled that the shareholder did not make an equity investment and excluded the loans from shareholder basis.

- Note Given to Shareholder for Unpaid Compensation

Wise, George W. v. Commissioner, TC Memo 1971-38, Borg, Joe E. v. Commissioner, 50 TC 257 (1968): The court ruled that the note could not be included in debt basis unless the shareholder included the amount of the note into income.

- Debt to trust as loan to shareholder-remainderman.

  Robertson, James Y. v. U.S., 73-2 USTC ¶9645: No consideration is given if the remainderman is also the trustee.

9.6 RULES FOR COMPUTING STOCK AND DEBT BASIS

Once you have identified initial stock basis, items that increase and decrease stock basis, and qualifying indebtedness, you now have all the components necessary to compute shareholder basis.

9.6.1 Timing of Adjustments to Stock and Debt Basis

All basis adjustments are determined as of the close of the corporation's taxable year, and the adjustments generally are effective as of that date. (Treas. Reg. §1.1367-1(d)(1); and PLR 200106009.) If a shareholder disposes of stock during the corporation's taxable year, the adjustments with respect to that stock are effective immediately prior to the disposition as will be discussed later.

9.6.2 Ordering Rules for Adjustments to Stock and Debt Basis

a. Pre-1997 Rules

IRC §1367 and Treas. Reg. §1.1367-1(e) provides the general and special ordering rules for adjusting basis for taxable years beginning before January 1, 1997 as follows:

General Rule:

- IRC §1367(a)(1)(A)-(C); Increase stock basis by separately and nonseparately stated income items and depletion deduction.
- IRC §1367(a)(2)(D)-(E); Decrease stock basis, but not below zero, by nondeductible, noncapital expenses, and the oil and gas depletion deduction.

- IRC §1367(a)(2)(B)-(C); Decrease stock basis, but not below zero, by separately and nonseparately stated losses and deductions.
- IRC §1367(a)(A); Decrease stock basis, but not below zero, by non-taxable distributions.

Special Rule:

- IRC §1367(b)(2)(A); Decrease debt basis, but not below zero, for losses/deductions in excess of those used in IRC §1367(a)(2)(B)-(E). Distributions do not reduce debt basis.
- IRC §1367(b)(2)(B); If unrestored debt basis exists and there is a 'net increase', restore debt basis by the 'net increase'. 'Net increase' is the excess of income items in IRC §1367(a)(1)(A)-(C) over the loss/deduction items in IRC §1367(a)(2)(A)-(E). This will be explained in detail later in this chapter.

Federal Regulations:

Treas. Reg. §1.1367-1(e) provides additional guidance as to the ordering rules contained in IRC §1367. According to this regulation, each adjustment category must be recognized in whole before recognizing the next category as follows:

Adjustment Category 1 (IRC §1367(a)(1)(A)-(C))	Separately stated income. Nonseparately stated income. The excess of the deductions for depletion.
Adjustment Category 2 (IRC §1367(a)(2)(D)-(E))	• Noncapital, nondeductible expenses. Oil and gas depletion deduction.
Adjustment Category 3 (IRC §1367(a)(2)(B)-(C))	• Separately stated losses/deductions. Nonseparately stated losses/deductions.

Treas. Reg. §1.1367-1(g) allows a shareholder to elect to have Adjustment Category 3 apply before Adjustment Category 2. The shareholder must make this election by attaching a statement to the return and must continue to use this elective ordering unless the Commissioner grants permission.

Note: Treas. Reg. §1.1367-1 and §1.1367-2 did not become effective until taxable years beginning on or after 1/1/94. Treas. Reg. §1.1367-3, however, stipulates that for taxable years beginning before 1/1/94, basis computations must be determined in a reasonable manner, taking into account the statute and the legislative history. Return positions consistent with Treas. Reg. §1.1367-1 and §1.1367-2 are reasonable.

b. Post-1996 Rules

For taxable years beginning on or after January 1, 1997, the ordering rules for basis adjustment changed. The adjusted basis of the shareholder's stock for purposes of computing the limitation on the amount of S corporation losses is computed after the shareholder's basis is reduced by the year's nontaxable distributions made to the shareholder. (IRC §1366(d)(1)(A)) IRC §1368(d) also provides that in order to determine the tax treatment of distributions made during the year the adjusted basis of the shareholder's stock must be increased by the shareholder's share of the S corporation's income items for the year, without reducing the basis for the shareholder's share of the S corporation's losses for the year.

Treas. Reg. §1.1367-1(f) reflects the rule described above by providing that adjustments to the basis of a shareholder's stock are made in the following order:

- Any increase in basis attributable to the income items described in IRC §1367(a)(1)(A) and (B), and the excess of the deductions for depletion described in IRC §1367(a)(1)(C);
- Any decrease in basis attributable to a distribution by the corporation described in IRC §1367(a)(2)(A);
- Any decrease in basis attributable to noncapital, nondeductible expenses described in IRC §1367(a)(2)(D), and the oil and gas depletion described in IRC §1367(a)(2)(E); and
- Any decrease in basis attributable to items of loss or deduction described in IRC §1367(a)(2)(B) and (C).

c. Special Rules for Debt Basis

- Shareholder Advances/Line of Credit

Treas. Reg. §1.1367-2(a) states that shareholder advances not evidenced by separate written instruments and repayments on the advances are treated as a single indebtedness.

Multiple Indebtedness
Pursuant to Treas. Reg. §1.1367-2(b)(3), if a shareholder holds more than one indebtedness at the close of the corporation's taxable year, as evidenced by separate written instruments or treated as separate obligations by the S corporation, each basis is reduced and restored proportionally based on total indebtedness. This provision is crucial for purposes of reducing and restoring basis of indebtedness.

- Special Rules - Treas. Reg. §1.1367-2

Reduction in Basis of Indebtedness:

If the debt is paid off or disposed of during the taxable year, it is not held by the shareholder at the close of that year and is not subject to basis reduction (Treas. Reg. §1.1367-2(b)(1)). This rule applies to terminations of shareholder interest in the S corporation during the taxable year as well. If the shareholder disposes of his/her stock during the year and debt had been paid off or disposed of prior to stock disposition, the debt is not held by the shareholder on the date of stock disposition and is not subject to basis reduction.

"If the shareholder holds more than one indebtedness at the close of the corporation's taxable year or, if applicable, immediately prior to the termination of the shareholder's interest in the corporation, the reduction in basis is applied to each indebtedness in the same proportion that the basis of each indebtedness bears to the aggregate bases of the indebtedness to the shareholder." (Treas. Reg. §1.1367-2(b)(3))

Restoration of Basis in Indebtedness:

Pursuant to Treas. Reg. §1.1367-2(c)(1), restoration rules apply only to debt held by the shareholder as of the beginning of the taxable year in which the "net increase" arises. Any previous reduction to the shareholder's basis in indebtedness must be restored before any net increase is applied to restore the shareholder's stock basis in the S corporation. In no event may the shareholder's basis of indebtedness be restored above the adjusted basis of the indebtedness under IRC §1016(a), excluding any adjustments under IRC §1016(a)(17) for prior taxable years, determined as of the beginning of the taxable year in which the net increase arises.

Pursuant to Treas. Reg. §1.1367-2(c)(2), if the shareholder holds more than one indebtedness as of the beginning of a corporation's taxable year, any net increase is applied first to restore the reduction of basis in any indebtedness repaid (in whole or in part) in that taxable year to the extent necessary to offset any gain that would otherwise be realized on the repayment. Any remaining net increase is applied to restore each outstanding indebtedness proportionally.

d. Allocation of Losses/Deductions

IRC §1366 and related regulations do not provide guidance for allocating deductible loss and deduction items that exceed basis. Treas. Reg. §1.469-2T(d)(6)(ii)(B) – coordination with other limitations on deductions that apply before IRC §469 – provides guidance for the allocation of losses/deductions in excess of stock and debt basis as follows.

Pursuant to Treas. Reg. §1.1366-2(a)(4), if any amount of an S corporation shareholder's pro-rata share of an S corporation's loss for the taxable year is disallowed under IRC §1366(d), a ratable portion of the taxpayer's pro-rata share of each item of deduction or loss of the S corporation is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of such item multiplied by the fraction obtained by dividing

(1) The amount of the shareholder's pro-rata share of S corporation loss that is disallowed for the taxable year, by
(2) The sum of the shareholder's pro-rata shares of all items of deduction and loss of the corporation for the taxable year."

Example A

	Schedule K-1 Items	Ratio	Stock & Debt Basis	Suspended Losses
Beginning Balance			$10,000	
Interest Income	$40,000		40,000	
Subtotal			50,000	
Ordinary Loss	-20,000	.13	-6,500	-$13,500
Capital Loss	-100,000	.67	-33,500	-66,500
Rental Loss	-30,000	.20	-10,000	-20,000
Total	-150,000	1.00	-50,000	-100,000
Ending Balance	$0		$0	-$100,000

After losses/deductions are allocated on a pro-rata basis, those that cannot be recognized currently are carried over and treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder (IRC §1366(d)(2)). Suspended losses/deductions are carried over and combined with the next year’s losses/ deductions. No distinctions are made in regards to when the actual losses/deductions were generated.

9.7 LOAN REPAYMENTS ON REDUCED DEBT BASIS

9.7.1 Debt Repayment on Single Debt (with Formal Note, not Line of Credit)

In Smith v. Commissioner (1967) 48 TC 872, the Tax Court had to decide how to treat loan repayments, from an S corporation to its shareholder, where the shareholder's basis in the loan was reduced below the face amount of the loan due to the shareholder's deduction of net operating losses generated by the S corporation. The Tax Court decided that a portion of the repayment should be treated as a return of the shareholder's basis and the rest of the repayment should be treated as taxable income to the shareholder. The court also set forth the following formula for determining the taxable income portion of the repayment:

[(Face Amount of Debt – Adjusted Debt Basis) / Face Amount of Debt x Loan Repayment]

The remaining portion of the loan repayment, after subtracting out the portion determined to be taxable income, is treated as a return of basis.

Example A

Face Amount of the Debt (principal balance) = $100,000.
Adjusted Debt Basis (basis in indebtedness) = $40,000.
Loan Repayment = $30,000.

Taxable Portion:
[(100,000 - 40,000) / 100,000] x 30,000 = $18,000.

Return of Basis:

$30,000 - 18,000 = $12,000.

After taking into consideration the loan repayment, face amount of the debt (principal balance) would be $70,000 (100,000 - 30,000) and the adjusted debt basis would be $28,000 (40,000 - 12,000).

The shareholder would report a capital or ordinary gain of $18,000 per return.

If a written instrument evidences the indebtedness, the taxable portion is treated as a capital gain. (Rev. Rul. 64-162, 1964-1 C.B. 304.) If no written instrument exists, the taxable portion is treated as an ordinary gain. (Rev. Rul. 68-537, 1968-2 C.B. 372.)

9.7.2 Debt Repayments on Separate Multiple Loans

Where the S corporation shareholder has made multiple loans to the S corporation, and each loan is evidenced by a formal written note, each loan will be treated separately for purposes of computing the shareholder's gain on repayments. (See Cornelius v. Commissioner (1972) 58 TC 417, affd. (5th Cir. 1974) 494 F.2d 465.) Therefore, each loan repayment will be associated with a specific loan (or note) and the gain on the repayment will depend upon the S corporation shareholder's basis in that specific loan.

If the S corporation passes through losses to the S corporation shareholder, the S corporation shareholder must reduce his or her basis in all of the outstanding loans to the S corporation, held by the S corporation shareholder at the close of the S corporation's taxable year, in the same proportion that the basis of each loan bears to the aggregate basis of all the loans (Treas. Reg. §1.1367-2(b)). If the S corporation passes-through income to the S corporation shareholder in subsequent years, the income is used to restore the S corporation shareholder's basis in all of the loans to the S corporation held by the S corporation shareholder at the beginning of the year in which the income arises (Treas. Reg. §1.1367-2(c)(1)). Where the S corporation shareholder held more than one loan at the beginning of the S corporation's taxable year, the increase in basis is applied:

First, to restore the reduction in basis repaid (in whole or in part) in that taxable year to the extent necessary to offset any gain that would otherwise be realized on the repayment; and

Any remaining increase in basis is applied to restore the basis in all of the other loans (Treas. Reg. §1.1367-2©(2)).

In summary, if the corporation has income (net increase) at the close of its taxable year, the “net increase” in the shareholder’s basis will be used to restore the basis of any loan repaid during the taxable year first. If the corporation has a “net decrease” at year-end, then the loss will not be computed (further reduce the debt basis) until after the loan repayment has been computed. The intention of this law is to minimize the gain on the shareholder loan repayments.

The above rules are applicable to the open account loan (line of credit) also (Treas. Reg. §1.1367-2(a)).

9.7.3 Debt Repayments on Open Single Account (Line of Credit)

In some instances, the shareholder’s loans to an S corporation will not be evidenced by a formal note. Instead the shareholder will loan money to the S corporation through a single account, such as a line of credit. When the S corporation needs money, it will just withdraw funds from that account, and when the S corporation has funds available, it will repay (deposit) funds back into the same account. This may occur several times a year and throughout several years.

In the case of loans on an open account, the key issue is whether to allow the taxpayer to “net” repayments against additional advances throughout the year, so that the taxable portion of the “net repayment” will be calculated at the end-of-the-year using the taxpayer’s end-of-the-year basis.

Many taxpayers have raised just such an issue and argued that they are not subject to tax at all where the additional advances throughout the year exceed the amount of the loan repayments received during the taxable year. Using the taxpayers’ interpretation, in the examples below, there would be no taxable repayment since total additional loans/advances ($6,500) exceed total repayments ($5,000).

Netting arguments should be disregarded because the law is clear and netting is not allowed. The primary case on the netting issue is Sam Novell et al v. Commissioner, TC Memo 1970-31. In that case the court specifically provided that:

“We think that the fraction of any payments in 1964 which represents income should have as its numerator the difference between the face amount of the total indebtedness to the shareholder and the shareholder’s basis therein and as its denominator the total indebtedness. By “total indebtedness” we mean the aggregate of the balance of Accounts No. 1 and No. 2 at the time of such payments. “

Following the court’s interpretation of the calculation of a repayment on an open line of credit, the following example calculates the taxable portion of the repayment.

Example A

Loan Repayments - Calculation of Taxable Portion
(Line of Credit Cases)

	Income or (Losses)	(A) Stock Basis	(B) Debt Basis	(C) Total Indebtedness	(D) Repayments	(C - D) Face Amount of Indebtedness	(C -B)/C * D Taxable Repayment
Initial Investment		11,000.00					
2002							
Loan			6,000.00	6,000.00			
Losses	(13,500.00)	(11,000.00)	(2,500.00)				
12/31/02		-	3,500.00	6,000.00	-	6,000.00	
2003							
Loan 1/15/03			4,000.00	4,000.00		4,000.00	
Net			7,500.00	10,000.00	-	10,000.00	
Repayment 3/15/03				-	(2,000.00)		
Subtotal			7,500.00	10,000.00	(2,000.00)	10,000.00	500.00
Nontaxable Repayment			(1,500.00)	(2,000.00)		(2,000.00)	
Loan 6/15/03			2,500.00	2,500.00		2,500.00	
Repayment 8/15/03							
Subtotal			8,500.00	10,500.00	(3,000.00)	10,500.00	571.43
Nontaxable Repayment			(2,428.57)	(3,000.00)		(3,000.00)	
Income/Loss	0						
Adj. Basis 12/31/03		-	6,071.43	7,500.00		7,500.00	

Note 1: The face amount is the amount any "net increase" will restore debt basis. Net increases can only restore debt basis to its face amount. (Treas. Reg. section 1.1367-2(c)(1).)
Note 2: Under the old method of "netting", it is interesting to note that the total loans of $6,500 exceed the repayments of $5,000 and there would not have been a taxable gain.

3/15/03 repayment taxable portion: $2,000 x (10,000-7,500)/10,000 = 500
8/15/03 repayment taxable portion: $3,000 x (10,500 - 8,500)/10,500 = 571

The above example assumes that there is no income or loss for the year 2003. The next example will show how the calculation will be done when there is a loss “net decrease” for the year.

Example B

LOAN REPAYMENTS - CALCULATION OF TAXABLE PORTION
(Line of Credit Cases)

	Income or (Losses)	(A) Stock Basis	(B) Debt Basis	(C) Total Indebtedness	(D) Repayments	Face Amount of Indebtedness	(C -B)/C * D Taxable Repayment
Initial Investment		11,000.00					
2002							
Loan			6,000.00	6,000.00			
Losses	(13,500.00)	(11,000.00)	(2,500.00)				
12/31/02		-	3,500.00	6,000.00	-	6,000.00	
2003							
Loan 1/15/03			4,000.00	4,000.00		4,000.00	
Net			7,500.00	10,000.00	-	10,000.00	
Repayment 3/15/03				-	(2,000.00)		
Subtotal			7,500.00	10,000.00	(2,000.00)	10,000.00	500.00
Nontaxable Repayment			(1,500.00)	(2,000.00)		(2,000.00)	
Loan 6/15/03			2,500.00	2,500.00		2,500.00	
Repayment 8/15/03					(3,000.00)		
Subtotal			8,500.00	10,500.00	(3,000.00)	10,500.00	571.43
Nontaxable Repayment			(2,428.57)	(3,000.00)		(3,000.00)	
Income/Loss	(1,500.00)		(1,500.00)				
Adj. Basis 12/31/03		-	4,571.43	7,500.00		7,500.00	

Note 1: The face amount is the amount any "net increase" will restore. Net increases can only restore debt basis to its face amount.

Everything is the same, even the taxable portion of the repayments are the same. Except the ending balance is different because the net decrease won't be computed until after the loan repayment computation has been completed.

The third example will show how the calculation will be done when there is a net increase at the close of the corporation's taxable year.

Example C

LOAN REPAYMENTS - CALCULATION OF TAXABLE PORTION
(Line of Credit Cases)

	Income or (Losses)	(A) Stock Basis	(B) Debt Basis	(C) Total Indebtedness	(D) Repayments	Face Amount of Indebtedness	(C -B)/C * D Taxable Repayment
Initial Investment		11,000.00					
2002							
Loan			6,000.00	6,000.00			
Losses	(13,500.00)	(11,000.00)	(2,500.00)				
12/31/02		-	3,500.00	6,000.00	-	6,000.00	
2003							
Increase from n.i.			1,500.00				
Loan 1/15/03			4,000.00	4,000.00		4,000.00	
Net			9,000.00	10,000.00	-	10,000.00	
Repayment 3/15/03				-	(2,000.00)		
Subtotal			9,000.00	10,000.00	(2,000.00)	10,000.00	200.00
Nontaxable Repayment			(1,800.00)	(2,000.00)		(2,000.00)	
Loan 6/15/03			2,500.00	2,500.00		2,500.00	
Repayment 8/15/03							
Subtotal			9,700.00	10,500.00	(3,000.00)	10,500.00	228.57
Nontaxable Repayment			(2,771.43)	(3,000.00)		(3,000.00)	
Income/Loss	1,500.00						
Adj. Basis 12/31/03		-	6,928.57	7,500.00		7,500.00	

Note 1: The face amount is the amount any "net increase" will restore. Net increases can only restore debt basis to its face amount.

Note 2: Under the old method of "netting", it is interesting to note that the total loans of $6,500 exceed the repayments of $5,000

3/15/03 repayment taxable portion: $2,000 x (10,000 – 9,000)/10,000 = $200
8/15/03 repayment taxable portion: $3,000 x (10,500 – 9,700)/10,500 = $228.57

You can see the taxable amounts are less than the previous two examples because the S corporation has income (net increase) for the year and can restore the debt basis before the computation of the taxable repayments.

In summary, Treas. Reg. §1.1367-2 and the Tax Court's decision in Novell, supra, indicate that:

- Taxpayers cannot net repayments and advances occurring within the same taxable year;
- Each particular repayment stands alone for purposes of determining the taxable portion of each repayment; and
- The taxability of each repayment will be determined as of the date of the repayment (taking into account the rules for net increases discussed above).

9.8 APPLICATION OF THE BASIS RULES - PROBLEMS

Following is a series of problems detailing the intended application of the basis rules under the code, regulations, and corresponding court decisions.

Problem 1	General Rule - Stock Basis
Problem 2	General Rule - Stock Basis with Suspended Losses
Problem 3	General and Special Rule - Stock and Debt Basis Reduced to Zero
Problem 4	General Rule - Distribution in Excess of Stock Basis with Existing Debt Basis
Problem 5	Special Rule - Debt Restoration
Problem 6	General Rule - Unrestored Debt and Net Decrease
Problem 7a	Ordering Rules – 1996 and Prior
Problem 7b	Ordering Rules - 1997 and After
Problem 7c	Ordering Rules Example - 1997 and After
Problem 8a	Ordering Rules/Proration of Suspended Losses - 1996 and Prior
Problem 8b	Ordering Rules/Proration of Suspended Losses 1997 and After
Problem 9	Ordering Rules/Proration of Suspended Losses - 1996 and Prior
Problem 10	Debt Repayment/Debt Repaid in Part
Problem 11	Debt Repayment/Debt Paid in Full During Year - Net Increase
Problem 12	Allocation on a Per Share, Per Day Basis

9.9 ELECTION TO DIVIDE THE TAXABLE YEAR

Problem 12 of this section illustrates how income (losses) is allocated when there is an ownership change during the year. As stated in that problem, it assumes that the S corporation generates income and losses evenly throughout the year. To alleviate potential distortion of income (losses) allocated to the shareholders involved in ownership changes, special provisions are available to allow the S corporation to divide its taxable year into two short years - the first short year ending at the close of the day on which the qualifying ownership change occurs and the second short year covering the remaining taxable year.

9.9.1 Making the Election

Treas. Reg. §1.1368-1(g)(2)(iii) requires the S corporation to file a statement with its return stating that an election is being made under this regulation, the date of election, the qualifying event, and a statement that each shareholder who held stock in the corporation during the taxable year consents to this election with their respective signatures. Note: An election made under this regulation is irrevocable.

9.9.2 Effective Date

An election for qualifying dispositions is effective for taxable years beginning on or after 1/1/94. For taxable years prior to 1/1/94, only entire stock dispositions were allowed to make this election.

9.9.3 Dispositions Qualifying for This Election

If an entire ownership interest is disposed of during the taxable year (IRC §1377(a)(2)), or
When a qualifying disposition occurs for taxable years beginning on or after 1/1/94 (Treas. Reg. §1.1368-1(g)(2)(ii)):

- A disposition by a shareholder of 20% or more of the outstanding stock of the corporation in one or more transactions during any 30-day period during the corporation's taxable year,
- A redemption treated as an exchange under IRC §302(a) or IRC §303(a) of 20% or more of the outstanding stock of the corporation from a shareholder in one or more transactions during any 30 day period during the corporation's taxable year, or
- An issuance of an amount of stock equal to or greater than 25% of the previously outstanding stock to one or more new shareholders during any 30 day period during the corporation's taxable year.

This election cannot be made pursuant to the death of a shareholder. Therefore, items of income and loss would be allocated on a pro-rata basis as contained in Problem 12 of section 9.8 and reported on the shareholder's final return (IRC §1366(a)(1)). Income and losses after the shareholder's death would be reported on the fiduciary return or by the beneficiary/purchaser of the decedent's stock.

9.9.4 Mechanics of Dividing the Taxable Year

Division of a taxable year into two short years affects only the allocation of income (losses) to the shareholders. It does not require the S corporation to file separate returns. At the end of the taxable year, the S corporation files one return with Schedule K-1's reflecting allocation of income (losses) for the divided taxable year. A corporation making this election must treat the short years as separate taxable years for purposes of:

- Allocating items of income and loss,
- Making adjustments to the AAA,

- Making adjustments to earnings and profits,
- Making adjustments to shareholder basis,
- Determining the taxability of distributions.

9.10 NONLIQUIDATING STOCK SALES/DISPOSITIONS

9.10.1 Computing Gain (Loss)

Stock and debt basis must be adjusted for the shareholder's pro-rata share of income and loss items as of the last day in which the shareholder owned stock in the corporation. Pro-rata shares are determined either (1) on a per share, per day basis or (2) by dividing the S corporation's taxable year pursuant to an election involving a qualifying disposition. The gain (loss) on the nonliquidating stock sale/disposition reflects the difference between the sales proceeds and the adjusted stock basis. Adjusted debt basis is not used in computing the gain (loss).

Example A

	Losses from Prior Year	Schedule K-1 Items	Total Current Items	Stock Basis	Debt Basis	Actual Debt
Beginning Balance				$0	$0	$100,000
Ordinary Income		$300,000	$300,000			
Capital Loss	-$50,000	-70,000	-120,000			
Rental Loss	-$20,000	-$15,000	-35,000			
Net Increase			$145,000	45,000	100,000	
Ending Balance				45,000	$100,000	$100,000
Proceeds from Stock Sale				300,000		
Gain (loss) on Stock Sale				$255,000		

Disregarding other applicable limitations, the shareholder would report the following amounts per return:

Ordinary Income, $300,000 to Schedule B.
Capital Loss, $120,000 to Schedule D.
Rental Loss, $35,000 to Schedule E.
Capital Gain, $255,000 to Schedule D [stock sale].

Note: The adjusted debt basis of $100,000 is not used in computing the gain (loss) on the stock sale.

9.10.2 Treatment of Suspended Losses in a Nonliquidating Stock Sale / Disposition

Loss/deduction items in excess of stock and debt basis are treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder, and therefore, belong to the shareholder who owns the stock, not to the stock itself (IRC §1366(d)(2)). As a result, no part of the excess losses/deductions can be carried over and used by the new shareholder. Gain on the stock disposition does not increase the disposing shareholder's basis.

Example A

	Carryover Losses from Prior Year	Schedule K-1 Items	Total Current Items	Stock Basis	Current Suspended Losses
Beginning Balance				$0	
Interest Income		$10,000	$10,000	10,000	
Ordinary Loss	-$50,000	-70,000	-120,000	-7,742	-$112,258
Rental Loss	-20,000	-$15,000	-35,000	-2,258	-32,742
Net Decrease			-145,000		
Ending Balance				0	
Proceeds from Stock Sale				300,000	

Gain (loss) on Stock Sale	$300,000

Disregarding other applicable limitations, the shareholder would report the following amounts per return:

Interest Income, $10,000 to Schedule B.
Ordinary Loss, $7,742 to Schedule E.
Rental Loss, $2,258 to Schedule E.
Capital Gain, $300,000 to Schedule D [stock sale].

The following losses/deductions "belong" to the shareholder disposing of his/her stock and will be lost. They cannot be carried over and used by the new shareholder.
Ordinary Loss, $112,258.
Rental Loss, $32,742.

Note: Proceeds from the stock sale/disposition totaling $300,000 do not increase basis for purposes of recognizing current suspended losses.

a. Treatment of Suspended Losses Incident to Divorce

Private Letter Ruling 9552001 (August 31, 1995) addresses the transferability of suspended losses incident to a divorce when each spouse separately owns shares. The ruling concluded that the wife cannot deduct losses disallowed and suspended under IRC §1366(d)(1) at a time when the former husband owned the S corporation stock. IRC §1366(d)(2) provides that any loss disallowed by the basis limitation in IRC §1366(d)(1) is treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder. Prior to the enactment of IRC §1366(d)(2), an S corporation shareholder was not permitted to carryover losses. IRC §1366(d)(2) provides an S corporation shareholder with the opportunity to carryover losses indefinitely. In permitting the shareholder to carryover losses that would otherwise expire, Congress restricted the transfer of any losses to another shareholder. The use of the words "with respect to that shareholder" in IRC §1366(d)(2) requires that all losses be personal to a shareholder and that the losses not be transferred in any manner.
IRC §1041 does not contradict the ruling. No gain or loss is recognized on the husband's transfer of his stock to his wife. The transfer is treated as a gift;

therefore, the wife's basis in the stock is the husband's adjusted basis in the stock at the time of the transfer.

In the Private Letter Ruling, the S corporation stock was separate property prior to the divorce. Little guidance has been provided regarding community property laws and the role they play in determining stock ownership prior to the divorce in which one spouse is awarded sole ownership incident to divorce. If community property laws are a factor and the couple resides in a community property state in which the S corporation stock is clearly not separate property prior to the divorce, IRC §1366(d)(2) would restrict the transfer of suspended losses between spouses incident to the divorce.

b. Treatment of Suspended Losses Pursuant to Death of Spouse

As with divorce, little guidance has been provided regarding community property laws and the role they play in determining stock ownership pursuant to the death of a spouse. However, the same logic applies. If community property laws are a factor and the couple resides in a community property state in which the S corporation stock is clearly not separate property prior to the death, IRC §1366(d)(2) would restrict the transfer of the decedent's suspended losses to the surviving spouse.

Keep in mind that the decedent's stock basis is adjusted to the fair market value at the date of death (or alternate valuation date if elected). If the stock reverts to the surviving spouse, only those shares acquired from the decedent will receive a stepped-up basis.

9.10.3 Treatment on Repayment of Shareholder Loans that have an Unrestored Debt Basis

IRC §1016(a)(17) states that the adjusted basis for determining the gain or loss from the sale or other disposition of property shall be the basis adjusted to the extent provided in IRC §1367 in the case of indebtedness owed to shareholders of an S corporation. Rev. Rul. 64-162 expands on this code section as follows:

"Where a shareholder-creditor of an electing small business corporation has reduced his basis in the corporation's note by the amount by which his share of the corporation's net operating loss sustained in a prior year exceeded his basis in the corporations stock, the repayment of the note (exclusive of interest) is considered to be an amount received in exchange for a capital asset, where the note is a capital asset in the shareholders hands. Installments received in_retirement of the note must be allocated in part to a return of the shareholder's basis in the loan and in part to income."

This revenue ruling recharacterized indebtedness, evidenced by a written instrument, to a capital asset. Repayments on the reduced basis indebtedness would be allocated part to return of the shareholder's basis in the loan and part to income regardless of whether the individual is a current or former shareholder of the S corporation. If no written instrument exists, there is no sale or exchange when the debt is paid. Thus, a payment by an S corporation of a debt to a shareholder that is carried on an open account will be ordinary income to the extent of the amount paid over the adjusted basis of indebtedness (Rev. Rul. 68-537, 1968-2 CB 372).

Example A

	Debt Basis	Actual Debt
Balance on the Date of Stock Disposition	$20,000	$180,000
Loan Repayment After Stock Disposition		-100,000
Return of Debt Basis [Deemed Debt Repayment]	-11,111	
Remaining Balance	$8,889	$80,000

Taxable Portion of Loan Repayment:

[(180,000 - 20,000) / 180,000] x 100,000 = $88,889.
Deemed Debt Repayment [Return of Debt Basis]:
$100,000 - 88,8889 = $11,111.

The shareholder would report a capital or ordinary gain of $88,889.

If the note then became uncollectible, the shareholder would be entitled to a bad debt deduction of $8,889 - his/her adjusted basis in the note.

9.11 COMPLETE LIQUIDATION - COMPUTING GAIN (LOSS)

Please refer to Chapter 15 - S Corporation Liquidation.

9.12 POST TERMINATION TRANSITION PERIOD

Recall that items of income, loss, and deduction affecting stock and debt basis are treated as incurred on the last day of the S corporation taxable year. Special provisions apply in cases where losses/deductions were limited due to insufficient basis if it is the last taxable year of a corporation for which it is an S corporation (IRC §1366(d)(3)).
These special provisions refer to the "post termination transition period." The aggregate losses/deductions lost due to insufficient basis are treated as incurred on the last day of the 'post termination transition period'. In other words, the shareholder is allowed a grace period in which to make additional stock contributions to the S corporation for purposes of recognizing suspended losses/deductions. There are no provisions for recognizing losses/deductions against debt basis during the post termination transition period.
The post termination transition period means (IRC §1377(b)):

- The period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of (1) the day which is one year after such last day, or (2) the due date for filing the return for such last year as an S corporation (including extensions) (IRC §1377(b)(1)(A) and pre-1997 SBA §1377(b)(1)(A)); and
- The 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer which follows the termination of the corporation's election and which adjusts a subchapter S item of income, loss, or deduction of the corporation arising during the S period (as defined in §1368(e)(2)), and
- The 120-day period beginning on the date of a determination that the corporation's election under IRC §1362(a) had terminated for a previous taxable year.

Example A

Last S Corporation Year:	**Schedule K-1 Items**	**Stock Basis**	**Debt Basis**	**Suspended Items**
Beginning Balance, 1/1/03		$10,000	$100,000	$0
Ordinary Income	5,000	5,000		
Subtotal		15,000	100,000	

IRC §1231 Loss	-250,000	-15,000	-100,000	$135,000
Ending Balance, 12/31/03		0	0	
Post Termination Transition Period:				
Capital Contributions, 12/31/04		120,000		
Subtotal		120,000		
Suspended Losses		-120,000		-120,000
Ending Balance, 12/31/04		$0		$15,000

Disregarding other applicable limitations, the shareholder would report the following amounts per return:

Last S Corporation year:
Ordinary Income, $5,000 to Schedule E.
1231 Loss, $115,000 to Form 4797.

Post Termination Transition Period:
1231 Loss, $120,000 to Form 4797.

The shareholder would lose the following losses/deductions:
1231 Loss, $15,000.

The shareholder's basis in stock, for purposes of determining the gain or loss on stock disposition, is zero. Future loan repayments would be taxable in whole as either capital or ordinary gains. If the shareholder had made a loan to the S corporation during the post termination transition period, he/she still could not have recognized the suspended $15,000.

9.13 INTERACTION BETWEEN SUSPENDED LOSSES AND NET OPERATING LOSS CARRYOVERS.

Because California allows only a percentage (50%-60%) of net operating losses to be carried over for tax years beginning before January 1, 2004 (R&TC §24416(b)(1)), it is more beneficial for a shareholder to suspend losses/deductions due to insufficient basis when they have a taxable loss for those years.

Example A Sufficient Basis with NOL Carryover

	Schedule K-1 Items	Stock/Debt Basis	Suspended Losses	Per Return
Beginning Balance		$2,000,000		
Interest Income	$10,000	10,000		$10,000
Ordinary Loss	-1,000,000	-1,000,000	0	-$1,000,000
Ending Balance		$1,010,000		
Net Operating Loss				-990,000
Net Operating Loss Carryover (60%)				-594,000
Tax benefit from NOL carryover @ 9.3% *				$55,242

- The tax rate depends on the tax year.

Example B Insufficient Basis

	Schedule K-1 Items	Stock/Debt Basis	Suspended Losses	Per Return
Beginning Balance		$0	$0	
Interest Income	$10,000	$10,000		
Ordinary Loss	-1,000,000	-10,000	$990,000	-$10,000
Ending Balance		$0		
Net Operating Loss	0			
Allowable Future Losses	$990,000			
Tax benefit from basis limitation @ 9.3% *	$92,070			

- The tax rate depends on the tax year.

In Example A, the shareholder had sufficient basis to recognize 100% of his Schedule K-1 income and losses. Assuming this was the shareholder's only source of income (loss), a net operating loss was generated. California imposes a net operating loss carryover limitation (60% in this example). As a result, the shareholder "lost" 40% of his pro-rata share of losses/deductions from the S corporation.

In Example B, however, the shareholder had insufficient basis. His pro-rata share of losses/deductions in excess of stock and debt basis were suspended and allowed to be carried over in full into the next tax year. As a result, the shareholder did not "lose" any excess losses/deductions pursuant to the net operating loss limitations.

9.14 ALTERNATIVE MINIMUM TAX & SUSPENDED LOSSES

The S corporation is not subject to AMT; however, there will be AMT adjustment and preference items generated by the S corporation that affect the shareholder's AMT computation. These AMT items will be shown on Schedule K-1.

For purposes of determining the AMT adjustment, you must compute shareholder basis separately for Regular Tax and for AMT. IRC §59(h) states that limitation of IRC §1366(d) shall be applied for purposes of computing the alternative minimum taxable income of the taxpayer for the taxable year with the adjustments of IRC §56, IRC §57, and IRC §58.

Example A

	Schedule K-1 Items	Stock Basis Regular Tax	Suspended Losses Regular Tax	Stock Basis AMT	Suspended Losses AMT
Year 1					
Beginning Balance		$10,000	$0	$10,000	$0
Regular Tax:					
Interest Income	$20,000				
Ordinary Loss	-100,000				
Net Decrease	-80,000	-10,000	-70,000		
AMT:					
Interest Income	20,000				
Ordinary Loss	-100,000				
AMT Depreciation	90,000				
Net Increase	$10,000			10,000	0
Ending Balance		$0	-$70,000	$20,000	$0

	Schedule K-1 Items	Stock Basis Regular Tax	Suspended Losses Regular Tax	Stock Basis AMT	Suspended Losses AMT
Year 2					
Beginning		$0	-$70,000	$20,000	$0

Balance					
Regular Tax					
Capital Gain	$500,000				
Ordinary Loss	-25,000				
Suspended Loss	-70,000				
Net Increase	405,000	405,000			
AMT					
Capital Gain	500,000				
Ordinary Loss	-25,000				
AMT Basis Adj.	-10,000				
AMT Depreciation	-25,000				
Net Increase	$440,000			440,000	
Ending Balance		$405,000	$0	$460,000	$0

The AMT adjustment to be reported on Schedule P is the difference between the net increase (decrease) actually recognized against stock and debt basis for AMT and Regular Tax. In Year 1, there is an AMT adjustment of +20,000 [10,000 - (-10,000)]. In Year 2, there would be an AMT adjustment of +35,000 (440,000 - 405,000).

When the S corporation stock is sold/disposed, the AMT basis adjustment will be the difference between ending Regular Tax and AMT stock basis.

9.15 INFORMATION DOCUMENT REQUESTS

Following are suggestions for information and documents to be requested from the shareholder:

- Computation of shareholder basis: adjusted stock basis, adjusted debt basis, and actual debt. Request computations covering either (a) the first year as a California S corporation to present or (b) the first open statute year to present.
- Copies of shareholder returns and California Schedule K-1's. (Request this information only when it is not available in-house.)
- Supporting documentation to substantiate the shareholder's initial capital contribution. (Use discretion if the corporation was incorporated many years ago.)
- Copies of notes for all loans made to the corporation.
- Copies of canceled checks, or other documents, to support the transfer of money from the shareholder to the S corporation. Request corporate journal entries to verify how the corporation booked the loan.
- Copies of journal entries computing interest payments on the notes and actual interest payments made.
- Copies of journal entries for actual repayment(s) on the note.
- Copies of trial balance workpapers for the years you are computing shareholder basis for. This includes the trial balance workpapers for all business enterprises that have intercompany transfers affecting shareholder basis.

Note: If the requested documentation is not available, consider alternative documentation. When requesting alternative documentation, please be sure that the information is reasonable and relevant to the issue under audit.

9.16 AUDIT TECHNIQUES

Maintaining the shareholder basis computation is the responsibility of the shareholder. Examination of this issue should be conducted at the shareholder level. Thus, contact letters must be sent to each shareholder, and examinations must be conducted independently.

If other issues are selected for examination, complete these issues before proceeding with the basis issue. Facts may change during the course of your examination, and the changes may adversely impact the tax potential of the shareholder basis issue.

Subsequently filed shareholder returns should always be obtained before completion of the audit to reevaluate tax potential.

Example A

The auditor obtains (1) ABC, Inc.'s corporate folder and (2) the sole shareholder of ABC, John's, 2003-2005 individual returns. He sends a contact letter to John on 12/1/06. The auditor determines that John recognized $1,000,000 of losses in excess of basis for tax year 2005. Prior to completion of the audit, John files his 2006 individual return reporting a pass-through capital gain from ABC, Inc. totaling $25,000,000.

Since John had sufficient basis in 2006 to take the $1,000,000 suspended loss from 2005, the tax potential on the 2005 adjustment will be impacted due to the timing adjustment.

Determine whether:

(a) The shareholder recognized losses against debt basis during any of the open statute years,
(b) The shareholder reported taxable loan repayments during any of the open statute years, and
(c) There would be overall tax effect after taking into consideration losses suspended at the shareholder basis level (100% carryover) versus losses recognized at the shareholder basis level but carried over as the net operating loss during the years in which there is a limitation on the net operating loss.

Problem 1

General Rule Stock Basis

	Schedule K-1 Items	Stock Basis
Beginning Balance		$10,000
Ordinary Income	$100,000	100,000
Subtotal		110,000
Charitable Contributions	-10,000	-10,000
Ending Balance		$100,000

Disregarding other applicable limitations, the shareholder would report the following amounts per return:

- Ordinary Income, $100,000 to Schedule E.
- Charitable Contributions, $10,000 to Schedule A.

In this example, the shareholder falls under the general rule:

1. Increase stock basis by income items.
2. Decrease stock basis, but not below zero, by loss/deduction items.

Problem 2

General Rule Stock Basis with Suspended Losses

	Schedule K-1 Items	Stock Basis	Suspended Loss
1. Beginning Balance		$10,000	
2. Ordinary Income	10,000	10,000	
Subtotal	20,000		
3. Capital Loss	-100,000	-20,000	-80,000

4. Ending Balance	$0	-80,000

Disregarding other applicable limitations, the shareholder would report the following amounts per return:

- Ordinary Income, $10,000 to Schedule E.
- Capital Loss, $20,000 to Schedule D.

The shareholder would currently suspend the following losses/deductions:

- Capital Loss, $80,000 ($100,000 - 20,000).

In this example, the shareholder falls under the general rule:

1. Increase stock basis by income items.
2. Decrease stock basis, but not below zero, by loss/deduction items.

The shareholder has no debt basis in which to recognize losses/deductions in excess of stock basis as provided under the special rule. As a result, a portion of the losses/deductions is currently suspended.

Problem 3

General and Special Rule Stock and Debt Basis Reduced to Zero

	Schedule K-1 Items	Stock Basis	Debt Basis
1. Beginning Balance		$10,000	$100,000
2. Ordinary Income	$40,000	$40,000	
Subtotal		50,000	100,000
3. Capital Loss	-150,000	-50,000	-100,000
4. Ending Balance		$0	$0

Disregarding other applicable limitations, the shareholder would report the following amounts per return:

- Ordinary Income, $40,000 to Schedule E.
- Capital Loss, $150,000 to Schedule D.

In this example, the shareholder falls under the general and special rules:

1. Increase stock basis by income items.
2. Decrease stock basis, but not below zero, by loss/deduction items.
3. Decrease debt basis, but not below zero, for loss/deduction items in excess of stock basis.

Problem 4

General Rule distribution in Excess of Stock Basis with Existing Debt Basis

	Schedule K-1 Items	Stock Basis	Debt Basis
1. Beginning Balance		$10,000	$10,000
2. Ordinary Income	$10,000	$10,000	
Subtotal		20,000	10,000
3. Distribution	-100,000	-20,000	
4. Ending Balance		$0	$10,000

Disregarding other applicable limitations, the shareholder would report the following amounts per return:

Ordinary Income, $10,000 to Schedule E.

Capital Gain, $80,000 to Schedule D - taxable distribution ($100,000 - 20,000).

In this example, the shareholder falls under the general rule:

1. Increase stock basis by income items.
2. Decrease stock basis, but not below zero, by loss/deduction items.

Under the special rule, the shareholder cannot reduce his/her debt basis by distributions. (IRC section 1368).

Problem 5

Special Rule Debt Restoration

	Schedule K-1 Items/Net Increase (Decrease)	Stock Basis	Debt Basis	Actual Debt
1. Beginning Balance		$0	$0	$10,000
2. Ordinary Income	$100,000			
3. Charitable Contributions	-5,000			
4. Debt Restoration	95,000		10,000	
Subtotal	85,000	0	10,000	10,000
5. Remainder Net Increase		85,000		
6. Ending Balance		$85,000	$10,000	$10,000

Disregarding other applicable limitations, the shareholder would report the following amounts per return:

Ordinary Income, $100,000 to Schedule E.

Charitable Contributions, $5,000 to Schedule A.

In this example, the shareholder falls under the special and general rule:

1. Special rule - Restore debt basis first by the amount of the net increase for the year.
2. General rule - Increase stock basis by income items.
3. General rule - Decrease stock basis, but not below zero, by loss/deduction items.

The special rule for debt restoration should be followed prior to the general rule only if the shareholder's actual debt was greater than his/her debt basis at the beginning of the year and there was a net increase for the year.

In this example, the shareholder had $10,000 actual debt at the beginning of the year, but had $0 debt basis. Schedule K-1 items affecting basis were aggregated resulting in a net increase of $95,000. As a result, unrestored debt basis was restored first only up to actual debt, $10,000. The remainder net increase of $85,000 was then applied to shareholder stock basis.

Problem 6

General Rule Unrestored Debt and Net Decrease

		Schedule K-1 Items Net Increase (Decrease)	Stock Basis	Suspended Loss	Actual Debt
1.	Beginning Balance		$0	$0	$10,000
2.	Ordinary Income	$10,000			
3.	Charitable Contributions	-110,000			
	Net Decrease	-100,000			
4.	Basis Adjustments				
	Ordinary Income		10,000		
	Charitable Contributions.		-10,000		
5.	Ending Balance		$0	$0	$10,000

Disregarding other applicable limitations, the shareholder would report the following amounts per return:
Ordinary Income, $10,000 to Schedule E.
Charitable Contributions, $10,000 to Schedule A.

The shareholder would currently suspend the following losses/deductions.
Charitable Contributions, $100,000 ($110,000 - 10,000).

In this example, the shareholder falls under the general rule:

1. Increase stock basis by income items.
2. Decrease stock basis, but not below zero, by loss/deduction items.

The shareholder is required to restore debt basis first under the special rule only if a net increase results. In this example, a net decrease of -$100,000 resulted. As a result, the shareholder follows the general rule.

Problem 7a

Ordering Rules - 1996 and Prior

	Stock Basis	
1. Beginning Balance	$10,000	
2. Schedule K-1: Interest Income	50,000	Adjustment Category 1
Subtotal	60,000	
3. Schedule K-1: 20% Meals & Entertainment	-5,000	Adjustment Category 2
Oil & Gas Depletion	-5,000	
Subtotal	50,000	
4. Schedule K-1: Ordinary Loss	-10,000	
Capital Loss	-10,000	
Charitable Contributions	-10,000	Adjustment Category 3
Subtotal	20,000	
5. Schedule K-1: Distributions	-20,000	Adjustment Category 4
6. Ending Balance	$0	

Disregarding other applicable limitations, the shareholder would report the following amounts per return:

- Interest Income, $50,000 to Schedule B.
- Oil and Gas Depletion, $5,000 to Schedule E.
- Ordinary Loss, $10,000 to Schedule E.
- Capital Loss, $10,000 to Schedule D.
- Charitable Contributions, $10,000 to Schedule A.

The distribution is a nontaxable return of capital.

Problem 7b

Ordering Rules - 1997 and After

		Stock Basis	
1.	Beginning Balance	$10,000	
2.	Schedule K-1: Interest Income	50,000	Adjustment Category 1
	Subtotal	60,000	
3.	Schedule K-1: Distributions (Non-taxable)	-20,000	Adjustment Category 2
	Subtotal	40,000	
4.	Schedule K-1: Ordinary Loss	-10,000	Adjustment Category 3
	Capital Loss	-10,000	
	Charitable Contributions	-10,000	
	Subtotal	10,000	
5.	Schedule K-1: Distributions	-5,000	Adjustment Category 4
	Oil & Gas Depletion	-5,000	
6.	Ending Balance	$0	

Disregarding other applicable limitations, the shareholder would report the following amounts per return:

- Interest Income, $50,000 to Schedule B.
- Oil and Gas Depletion, $5,000 to Schedule E.
- Ordinary Loss, $10,000 to Schedule E.
- Capital Loss, $10,000 to Schedule D.
- Charitable Contributions, $10,000 to Schedule A.

The distribution is a nontaxable return of capital.

Problem 7c

Ordering Rules Example - 1997 and After

1997 Items

Ordinary Income	180,000
Capital Gain	200,000
Section 1231 Loss	100,000
Distribution (non taxable)	380,000

Basis Adjustments

Ordinary Income	180,000
Capital Gain	200,000
Subtotal	380,000
Distribution	-380,000
End of year balance	0
Suspended Loss	-100,000

The shareholder could have taken the entire loss of $100,000 and a distribution of $280,000 as follows:

Basis Adjustments

Ordinary Income	180,000
Capital Gain	200,000
Subtotal	380,000
Section 1231 loss	-100,000
Subtotal	280,000
Distribution	-280,000
End of Year Balance	0

Problem 8a

Ordering Rules/Proration of Suspended Losses - 1996 and Prior

	Schedule K-1 Items	Stock Basis	Debt Basis	Actual Debt
1. Beginning Balance		$10,000	$10,000	$10,000
2. Adjustment Category 1:				
Interest Income	$10,000	10,000		
Subtotal		20,000		
3. Adjustment Category 2:				
20% Meals & Entertainment	-10,000			
Oil & Gas Depletion	-40,000			
Total Adjustments	-50,000	-20,000	-10,000	
Subtotal		0	0	
4. Adjustment Category 3:				
Ordinary Loss	-50,000			
Capital Loss	-100,000			
Charitable Contributions	-10,000			
5. Adjustment Category 4:				
Distributions	-100,000			
6. Ending Balance		$0	$0	$10,000

Proration of currently suspended losses:

	Total Loss	Loss Ratio	Allowed	Suspended Losses
20% Meal & Entertainment	-$10,000	.20	-$6,000	-$4,000
Oil & Gas Depletion	-40,000	.80	-24,000	-16,000
Total	-50,000	1.00	-30,000	-20,000
Ordinary Loss				-50,000

Capital Loss	-100,000
Charitable Contributions	-10,000
Total Suspended Losses	-$180,000

Problem 8b

Ordering Rules/Proration of Suspended Losses 1997 and After

	Schedule K-1 Items	Stock Basis	Debt Basis	Actual Debt
1. Beginning Balance		$10,000	$10,000	$10,000
2. Adjustment Category 1:				
Interest Income	$10,000	10,000		
Subtotal		20,000		
3. Adjustment Category 2:				
Distributions	-10,000	-10,000		
Subtotal		10,000		
4. Adjustment Category 3:				
20% Meals & Entertainment	-10,000			
Oil & Gas Depletion	-40,000			
Total Adjustments	-50,000	-10,000	-10,000	
Subtotal		0	0	
Adjustment Category 4:				
Ordinary Loss	-50,000			
Capital Loss	-100,000			
Charitable Contributions	-10,000			
Ending Balance		$0	$0	$10,000

Proration of currently suspended losses:

	Total Loss	Loss	Allowed	Suspended

		Ratio		Losses
20% Meal & Entertainment	-10,000	0.2	-4,000	-6,000
Oil & Gas Depletion	-40,000	0.8	-16,000	-24,000
Total	-50,000	1	-20,000	-30,000
Ordinary Loss				-50,000
Capital Loss				-100,000
Charitable Contributions				-10,000
Total Suspended Losses				-$190,000

Problem 9

Ordering Rules/Proration of Suspended Losses - 1996 and Prior

	Schedule K-1 Items	Debt Basis	Debt Basis	Actual Debt
1. Beginning Balance		$10,000	$100,000	$100,000
2. Adjustment Category 1:				
Interest Income	50,000	50,000		
Subtotal		60,000		
3. Adjustment Category 2:				
20% Meals & Entertainment	-10,000	-10,000		
Oil & Gas Depletion	-10,000	-10,000		
Subtotal		40,000		
4. Adjustment Category 3:				
Ordinary Loss	-50,000			
Capital Loss	-100,000			
Charitable Contributions	-10,000			
Total Adjustments	-$160,000	-40,000	-100,000	
Subtotal		0	0	

5. Adjustment Category 4:

Distributions	-100,000			
6. Ending Balance		$0	$0	$100,000

Proration of currently suspended losses:

	Total Loss	Loss Ratio	Allowed	Suspended Losses
Ordinary Loss	-$50,000	.31	-$43,400	$6,600
Capital Loss	-100,000	.63	-88,200	11,800
Charitable Contributions	-10,000	.06	-8,400	-1,600
Total	-$160,000	1.00	-140,000	-20,000

Problem 10

Debt Repayment / Debt Repaid in Part

	Schedule K-1 Items	Stock Basis	Debt Basis	Actual Debt
1. Beginning Balance		$10,000	$50,000	$50,000
2. Actual Debt Repayment 03/15/XX 10,000			-10,000	-10,000
Subtotal		$10,000	$40,000	$40,000
3. Ordinary Income	50,000	50,000		
Subtotal		60,000		
4. Capital Loss	-80,000	-60,000	-20,000	
Subtotal		0	20,000	
5. Ending Balance		$0	$20,000	$40,000

Disregarding other applicable limitations, the shareholder would report the following amounts per return:

Ordinary Income, $50,000 to Schedule E.
Capital Loss, $80,000 to Schedule D.
Capital or Ordinary Gain, to Schedule D (zero taxable portion of debt repayment).

In this example, the shareholder falls under the general rules:

1. General rule - increase stock basis by income items.
2. General rule - decrease stock basis, but not below zero, for losses/deductions.

(50,000-50,000)/(50,000 x 10,000) = 0

Since the net decrease won't be considered until after the computation of repayment, the total amount of the repayment is non-taxable.

Problem 11

Debt Repayment/Debt Paid in Full During Year - Net Increase

	Schedule K-1 Items	Stock Basis	Debt Basis	Actual Debt
1. Beginning Balance		$0	$10,000	$50,000
2. Ordinary Income	$50,000			
Capital Loss	-20,000			
Net Increase (Decrease)	30,000			
3. Restoration of Debt			30,000	
Subtotal			40,000	
4. Deemed/Actual Debt Repayment of $50,000			-40,000	-50,000
5. Ending Balance		$0	$0	$0

Computation of Deemed Debt Repayment:
Taxable Portion: [(50,000 - 40,000) / 50,000] x 50,000 = $10,000

[(Actual Debt - Adjusted Debt Basis) / Actual Debt] x Repayment

Deemed Debt Repayment: $50,000 - 10,000 = $40,000

(Actual Repayment - Taxable Portion)

Disregarding other applicable limitations, the shareholder would report the following amounts per return:

Ordinary Income, $50,000 to Schedule E.

Capital Loss, $20,000 to Schedule D.

Capital or Ordinary Gain, $10,000 to Schedule D (zero taxable portion of debt repayment).

In this example, the shareholder falls under the general and special rules:

1. Special rule - restore debt basis first by the amount of the net increase for the year.
2. General rule - increase stock basis by income items.
3. General rule - decrease stock basis, but not below zero, for losses/deductions.

The shareholder was unable to completely restore his/her debt basis prior to repayment in full and was, therefore, taxable on the unrestored portion as determined by formula.

Problem 12

Allocation on a Per Share, Per Day Basis

This example allocates the income (losses) among the shareholders when there was a stock ownership change during the year, but the outstanding shares of S corporation stock remained constant (IRC §1377(a)(1)).

On the first day of the taxable year (1/1), the S corporation had the following shareholders:

Shareholder	# Shares	
A	40	
B	40	
C	30	
	100	Total

On March 15, the S corporation had the following shareholders:

Shareholder	# Shares	
A	40	
B	30	
C	15	
D	15	
	100	Total

On the last day of the taxable year, the S corporation had the following income (losses):

Ordinary Income	$365,000
Capital Gain	73,000
Charitable Contributions	36,000

Compute the income (loss) on a per share, per day basis:

Income (loss) / [Total shares outstanding x # days in tax year these total shares were outstanding]

Ordinary Income: $365,000 / [100 x 365] = $10 per day

Capital Gain: $73,000 / [100 x 365] = $2 per day

Charitable Contributions: $36,000 / [100 x 365] = $1 per day