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SUBJECT: Calculation of Shareholder Basis in an S corporation When Some Years are Closed by the Statute of Limitations

QUESTION(S) PRESENTED

1. How is a shareholder's basis in an S corporation calculated for years in which the statute of limitations has closed in the following scenarios?
 - a. The S corporation has both items of income and deduction for the closed years. The shareholder did not report these items of income and deduction on the shareholder's personal income tax return for the closed years.
 - b. The S corporation has both items of income and deduction for the closed years. The shareholder reports all of these items of income and deduction on the shareholder's personal income tax return.
2. How are items of deduction and loss in excess of basis treated in the two scenarios described above?
3. Does Internal Revenue Code § 1016, the duty of consistency and/or the tax benefit rule require a shareholder that reported items of loss and deduction in excess of the shareholder's basis in a closed year to increase the shareholder's income in an open year by the amount of the erroneous items of income and loss reported?
4. Does a deduction for worthless stock in an open year result in a double deduction in the situation where a shareholder reported losses in excess of basis in a closed year?

CONCLUSION(S)

- Question 1:** How is a shareholder's basis in an S corporation calculated for years in which the statute of limitations has closed in the following scenarios?
- a. The S corporation has both items of income and deduction for the closed years. The shareholder did not report these items of income and deduction on the shareholder's personal income tax return for the closed years.

Conclusion #1(a): Basis is not increased for items of income. For items of deduction, basis is decreased but not below zero.

Example #1(a): Taxpayer is the sole shareholder in a California S corporation. The taxpayer's initial capital contribution to the S corporation was \$10,000. For the closed years (Years 1 to 3) the taxpayer did not report the S corporation's items of income and loss. What is the taxpayer's basis at the beginning of the open year (Year 4)?

	Basis at Beginning of Year	Income or Loss	Basis at End of Year
Year 1	10,000	20,000	10,000
Year 2	10,000	(15,000)	0
Year 3	0	(30,000)	0
Year 4	0		

- b. The S corporation has both items of income and deduction for the closed years. The shareholder reports all of these items of income and deduction on the shareholder's personal income tax return.

Conclusion #1(b). Basis is increased for items of income. Basis is decreased for items of loss and deduction but not below zero.

Example #1(b): Taxpayer is the sole shareholder in a California S corporation. The taxpayer's initial basis in the S corporation is zero. For the closed years (Years 1 to 3) the taxpayer reported the S corporation's items of income and loss. What is the taxpayer's basis at the beginning of the open year (Year 4)?

	Basis at Beginning of Year	Income or Loss	Basis at End of Year
Year 1	10,000	20,000	30,000
Year 2	30,000	(15,000)	15,000
Year 3	15,000	(30,000)	0
Year 4	0		

Question 2: How are items of deduction and loss in excess of basis treated in the two scenarios described above?

Question #2(a). Because the shareholder has not reported the items of loss or deduction, the shareholder may carry over any items of loss or deduction in excess of basis to future years.
 Example #2(a)

	Basis at Beginning of Year	Income or Loss	Basis at End of Year	Suspended Loss
Year 1	10,000	20,000	10,000	0
Year 2	10,000	(15,000)	0	5,000
Year 3	0	(30,000)	0	35,000
Year 4	0			

Conclusion 2(b): Because the shareholder has previously reported the items of loss or deduction, the shareholder has received the benefit of these items and they are no longer available. Therefore, although these items can be used to calculate the correct basis, the excess of these items over basis cannot be carried over to future years because such use of the losses would be a double deduction.

Example #2(b):

	Basis at Beginning of Year	Income or Loss	Basis at End of Year	Suspended Loss
Year 1	10,000	20,000	30,000	0
Year 2	30,000	(15,000)	15,000	0
Year 3	15,000	(30,000)	0	0
Year 4	0			

Question 3: Does Internal Revenue Code § 1016, the duty of consistency and/or the tax benefit rule require a shareholder that reported items of loss and deduction in excess of the shareholder's basis in a closed year to increase the shareholder's income in an open year by the amount of the erroneous items of income and loss reported?

Conclusion 3: Internal Revenue Code § 1016, the duty of consistency and/or the tax benefit rule does not require a shareholder that reported items of loss and deduction in excess of the shareholder's basis in a closed year to increase the shareholder's income in an open year by the amount of the erroneous items of income and loss reported.

Question 4: Does a deduction for worthless stock in an open year generated from income items in an open year result in a double deduction in the situation where a shareholder reported losses in excess of basis in a closed year?

Conclusion 4:

A worthless loss deduction is not a double deduction with respect to the previous loss deductions. The basis that permits the taxpayer to take a deduction was generated from the income items in the open year. It is not attributable to any basis that was previously used.

ANALYSIS AND DISCUSSION

I. Calculation of Basis

California follows federal law with respect to S corporations using the following statutory scheme. The Revenue and Taxation Code states that the Internal Revenue Code (IRC) provisions that relate to S corporations apply, except as otherwise provided. (Rev. & Tax Code, § 23800.)

The statutory authority for calculation of shareholder basis provides that basis in an S corporation's shareholder's stock is increased for any items income. (Int. Rev. Code, §§1367(a)(1).) In addition, basis is decreased (but now below zero) for any items of loss and deduction. (*Id.* at (a)(1).) Furthermore, an item of income must be included in a shareholder's gross income in order to increase the shareholder's basis in her S corporation stock. (*Id.* at (b)(1).)¹ In other words, if the item of income is not included in the shareholder's basis, than the shareholder's basis does not increase with respect to that item of income. (*Id.*)

Therefore, the statutory authority provides that a shareholder's basis is increased for items of income that are reported by the shareholder on his return. If the shareholder does not report an item of income on the shareholder's return, basis is not increased.

Finally, if the amount of losses and deductions exceed a shareholder's basis in stock, the excess amount will be carried over until the shareholder has sufficient basis to use a portion or all of the suspended losses. (Int. Rev. Code, § 1366(d).) However, this rule cannot apply in a situation in which the shareholder has already reported (albeit erroneously) these items of loss on the shareholder's return. The shareholder has already received the benefit of these items and further use would be a double deduction. (See e.g. *Stewart v. U.S.* (1984 9th Cir.) 739 F.2d 411.)

II. Authority to Require Reporting of Erroneous Losses as Income in Open Years

A. IRC Section § 1016/Double Deduction

Internal Revenue Code section 1016 addresses the proper adjustments to a taxpayer's basis in property with respect to certain events. One of the regulations under section 1016 states in relevant part that:

- (a) Adjustments must always be made to eliminate double deductions or their equivalents. Thus, in the case of the stock of a subsidiary company, the

¹ Int. Rev. Code section 1367(b)(1) reads in relevant part that:

(1) Income items. An amount which is required to be included in the gross income of a shareholder and shown on his return shall be taken into account under subparagraph (A) or (B) of subsection (a)(1) only to the extent such amount is included in the shareholder's gross income on his return, increased or decreased by any adjustment of such amount in a redetermination of the shareholder's tax liability.

basis thereof must be properly adjusted for the amount of the subsidiary company's losses for the years in which consolidated returns were made.

(Treas. Reg. §1.1016-6(a).)

The IRS promulgated this regulation in 1957. (See Treasury Decision 6265, 11-6-57.) I have been unable to locate any authority on the history of this regulation. However, based on the language of the regulation, it appears to have been directed at corporations that file consolidated returns.

The authority I found that applies this regulation does so in factual scenarios for which there is no mechanism to prevent a taxpayer from receiving a double benefit from the same item. For example, this regulation was applied where it was appropriate to allow the taxpayer a current deduction with respect to property (i.e. casualty loss) but there was no corresponding provision that required the taxpayer to decrease basis for either the amount of the casualty loss or the amount of compensation received. (See e.g. Revenue Ruling 90-61; Revenue Ruling 71-61 and PLR 8917051.)

In this request for technical advice, one of the questions presented is in essence whether the taxpayer can be required to report as income in a current year the amount of a loss deduction which was improperly taken (because of insufficient basis) by the taxpayer in a prior year. Treas. Reg. §1.1016-6(a) does not provide the authority to require the taxpayer to report as income the improper deduction because there appears to be a single improper use of a deduction by the taxpayer rather than an attempt to take a double deduction.

In contrast, there would be a double deduction in the scenario where the taxpayer improperly (because of insufficient basis) deducted a loss in a prior year and then argued that it should be considered a suspended loss that could be used in an open year.

In addition, FSA 200230030 does not appear to require a different result. The facts of FSA 200230030 are as follows.

The taxpayer was the sole shareholder of an S corporation and had an adjusted basis of \$20,000 in the S corporation at the beginning of Year 1. In Year 1, the S corporation had a \$50,000 capital loss. In Year 2, the S corporation had an ordinary loss of \$30,000. In Year 3, the S corporation had ordinary income of \$90,000.

Years 1 through 3 were barred by the statute of limitations. It appears that the taxpayer reported both the income and losses on his return in the barred years.

The IRS found that the taxpayer's basis at the beginning of Year 4 was \$30,000.² In essence, the IRS required the taxpayer to reduce his basis by an amount equivalent to the losses reported in excess of the taxpayer's basis in Years 1 and 2. One of the code sections relied on in their analysis is Treas. Reg. § 1.1016-6(a).

² Note that using the analysis and conclusion contained in this TAM, the taxpayers' basis at the beginning of year 4 would be \$90,000 with zero suspended losses.

However, the FTB cannot apply this FSA because it also relies in part on Internal Revenue Code section 6214(b³) to which the FTB does not conform. Furthermore, the IRS analysis is not explained in the FSA which makes it difficult to apply to any other factual situation than the one presented in the FSA. Finally, even if the FSA does apply, it is not authority for requiring the taxpayer to include in income the amount of losses in excess of basis taken on his return in barred years.

B. Duty of Consistency/IRC Section §1016

The "duty of consistency" is based in equity and requires that a taxpayer continue to file consistently with his earlier returns. The duty of consistency has the following elements:

..(1) A representation or report by the taxpayer; (2) on which the Commissioner has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner. If this test is met, the Commissioner may act as if the previous representation, on which he relied, continued to be true, even if it is not. The taxpayer is estopped to assert the contrary.

(*Ashman v. Commissioner* (2000 9th Circuit) 231 F.3d 541, 545.)

As noted above, the Ninth Circuit accepts the "duty of consistency". In addition, although the State Board of Equalization (SBE) has recognized and applied the "duty of consistency", it has not done so in an opinion which can be relied on as precedent. (See e.g. Appeal of Plott, Cal. St. Bd. Of Equal., February 2, 1999 and Appeal of Batinich Bros Inc., Cal St. Bd. Of Equal., April 21, 1993.) Therefore, the SBE's official position on the doctrine and how it might be applied is not clear.

Furthermore, it does not appear that the duty of consistency can be applied to force the taxpayer to report as income the amount of excess losses previously reported on the taxpayers return. In the closed years, the taxpayer treated the corporation as an S corporation and flowed thru the items on his return. In the open year, the taxpayer is also treating the corporation as an S corporation. Therefore, there is no inconsistency in the taxpayers' treatment of the return reporting.

The doctrine of duty of consistency could only work if FTB contends that in the open year a fiction is created that the S shareholder has a negative basis. In that case, any subsequent items of income would be applied first to "restore basis to zero". However, because the Internal Revenue Code expressly prohibits a negative basis, I would not recommend that the Department go forward based on the doctrine of duty of consistency. (See Int. Rev. Code section 1367(a)(2) and (b)(2).)

C. Tax Benefit Rule

³ Section 6214(b) allows for a computation of tax items in an open year using facts from closed years.

The tax benefit rule includes two separate concepts: a rule of inclusion and a rule of exclusion. (Bittker, B. *The Tax Benefit Rule* (1978) 26 UCLA L. REV 265, 271.) Historically, the rule of inclusion provides that when a taxpayer recovers or collects an item that was deducted in an earlier year, he is ordinarily taxed on the amount received. (*Bittker* at 265.) The rule of exclusion provides that a taxpayer will not be taxed on the collection or recovery to the extent the prior deduction did not reduce his tax liability. (*Id.*)

The threshold issue of the tax benefit rule is the rule of inclusion. (*Id.*) The rule of exclusion "serves to qualify its inclusionary requirement. . ." (*Bittker* at 272.)

The traditional formulation of the tax benefit rule was modified by the United States Supreme Court's decision in the companion cases of *Hillsboro National Bank v. Commissioner* and *Bliss Dairy, Inc. v. Commissioner* (1983) 460 U.S. 370. In *Hillsboro*, Justice O'Connor stated that it "is the **inclusionary** aspect of the rule" with which the court was concerned [emphasis added]. (*Hillsboro*, 460 U.S. at 380, fn. 12.) The rule of the case is described as follows:

.... [T]he tax benefit rule will "cancel out" an earlier deduction only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based. [footnote omitted] That is, if that event had occurred with the same taxable year, it would have foreclosed the deduction." . . . [T]he tax benefit rule must be applied on a case-by-case basis. A court must consider the facts and circumstances of each case in light of the purpose and function of the provisions granting the deductions.

(*Hillsboro* at 384.)

The classic example of the application of the tax benefit rule is the case in which the taxpayer takes a bad debt deduction and then in a later year is repaid for this debt.

The tax benefit rule does not appear to apply in this situation. This doctrine applies when the substantive reason for the deduction (bad debt) is inconsistent with subsequent events (i.e. collection of the debt for which the deduction was taken). There are no facts to suggest that the S corporation incorrectly took deductions for the items it expensed.

III. Worthless Stock Deduction

The following factual scenario is presented in the TAM. ABC is a wholly owned S corporation. The taxpayer's beginning basis in ABC was zero. Subsequently, ABC had \$1,000,000 of deductions in closed years that the taxpayer erroneously reported in full on his return. For the closed years, ABC did not have any income items.

In an open year, ABC has \$2,000,000 of income and a cash distribution of \$1,000,000. ABC then liquidates. The taxpayer claims a worthless stock deduction of \$1,000,000.00.

Using the authority described above, the taxpayer's basis as of the beginning of the open year should be as follows. Because there are no income items for the closed years, the taxpayer's basis in ABC would not increase from the beginning balance of zero. In

addition, the taxpayer does not have any suspended losses because he already received the benefit of those losses during the closed years.

For the open year, the taxpayer's basis would increase by \$2,000,000 of for the income and decrease by \$1,000,000 for the cash distribution. Therefore, the taxpayer has \$1,000,000 of basis remaining at the end of the year.

As noted previously, there is no statutory authority or doctrines of equity that would appear to apply to force the taxpayer to reported the previously deducted losses as items of income in the open year.

In addition, a worthless loss deduction (assuming the taxpayer met all the requirements) is not a double deduction with respect to the previous loss deductions. The basis that permits the taxpayer to take a deduction was generated from the income items in the open year. It is not attributable to any basis that was previously used.

IV. Possible Alternative Basis for Assessment

Note that a possible alternative basis for assessment if allowed by the specific facts is to treat the Shareholder as having made a loan to the corporation at the beginning of the closed years. The shareholder could then properly deduct items of deduction and loss against his debt basis. (Int. Rev. Code section 1366(d)(1)(B),

Subsequently, any items of income would go to restore debt basis before increasing stock basis. (Treas. Reg. § 1.1367-2(c).) In addition, any debt repayments where the debt basis had not been completely restored would be taxable. (See Rev. Rul. 64-162.)

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