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| Requested Date: | 06/30/2017 |
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**SUBJECT: Calculation of Shareholder Basis in an S corporation When Some Years are Closed by the Statute of Limitations**

## QUESTIONS PRESENTED

1. Does the guidance contained in Internal Revenue Service Technical Advice Memorandum ("IRS TAM") 200619021 apply, under California law, to calculate a shareholder's basis in an S corporation when the shareholder improperly claimed losses in excess of stock and debt basis in a year closed by the statute of limitations?

2. Does the guidance contained in IRS TAM 200619021 address how to calculate a shareholder's basis in an S corporation when the shareholder improperly failed to recognize income from a distribution in excess of stock basis in a year closed by the statute of limitations?

## CONCLUSIONS

1. Yes. When the shareholder improperly claims losses in excess of stock and debt basis in a year closed by the statute of limitations, a shareholder's basis in an S corporation is calculated by the method provided for in IRS TAM 200619021 by holding the excess losses in a suspense account pursuant to Internal Revenue Code ("IRC") section 1366(d)(2) to be used in future years in computing the shareholder's basis in the S corporation.

2. No. The guidance contained in IRS TAM 200619021 does not address the situation where a shareholder improperly failed to recognize income from a distribution in excess of stock basis in a year closed by the statute of limitations.

**ANALYSIS AND DISCUSSION**

*Background*

The Franchise Tax Board ("FTB") issued Technical Advice Memorandum ("FTB TAM") 20030305 on June 24, 2005 which declined to follow Internal Revenue Service Field Service Advice Memorandum ("IRS FSA") 200230030's treatment of S corporation shareholder basis when excess losses were claimed by the shareholder in a year barred by the statute of limitations. The FTB declined to follow IRS FSA 200230030's treatment of deductions claimed in excess of basis because in addition to citing as authority IRC section 1366(d) and Treasury Regulation sections 1.1016-6, to which the Revenue and Taxation Code ("RTC") conforms,[1] the IRS FSA also cited IRC section 6214(b), which California does not conform to, as an authority for its treatment of S corporation basis.

After FTB TAM 20030305 was issued, facts similar to those raised in IRS FSA 200230030 were addressed again in IRS TAM 200619021. IRS TAM 200619021 cites the same authorities for support as IRS FSA 200230030, including IRC section 6214(b). Since IRS TAM 200619021 is new authority issued after FTB TAM 20030305, the FTB's Audit Division (Pass Through Entity Audit Program – S Corporations), requested a Legal Opinion to address how to reconcile a shareholder's basis in an S corporation when the FTB determines that the shareholder improperly claimed losses in excess of stock and debt basis in a year closed by the statute of limitations. The FTB's Audit Division also requested a Legal Opinion on whether IRS TAM 200619021 applies when a shareholder received a distribution in excess of stock basis and failed to recognize the excess amount as income in a year closed by the statute of limitations.

*Losses in Excess of Basis from a Closed Tax Year*

California tax law generally conforms to the IRC's treatment of S corporation shareholders.[2] IRC sections 1366 through 1368 provide for the pass-through of items of income, losses, deductions, and credits from S corporation stock and the related adjustments to the shareholder's stock basis. A shareholder is not permitted to recognize pass-through losses and deductions from an S corporation if those losses and deductions exceed the shareholder's basis in the S corporation stock and the S corporation's indebtedness to the shareholder.[3] Additionally, a shareholder must recognize taxable income when distributions from the S corporation exceed the shareholder's basis in the stock.[4] Further, a shareholder shall increase basis in the S corporation stock to reflect pass-through income from the S corporation, then

[1] See RTC section 23800 as modified by RTC sections 23082.5 and 18031.
[2] See RTC sections 17087.5 and 23800.
[3] IRC section 1366(d)(1).
[4] IRC section 1368(b)(2).

decrease basis first for distributions, and then decrease basis for the pass-through of items of loss and deduction.[5] When making these adjustments to basis the shareholder's basis may never be decreased below zero.[6] If pass-through losses exceed the shareholder's basis, then the shareholder can only recognize the losses to the extent of basis, and IRC section 1366(d)(2) instructs that the amount that the losses exceed basis (the excess loss) is suspended and carried over to subsequent years until there is sufficient basis to use the excess loss.[7]

Part of IRS TAM 200619021 addresses the situation where a shareholder recognizes pass-through losses that exceed the stock basis in a year that is now closed for adjustment due to the expiration of the statute of limitations. The IRS TAM instructs that the amount of loss recognized in excess of basis is held in the IRC section 1366(d)(2) suspense account to be used in future open years solely for purposes of computing the shareholder's basis. Thus, the IRS TAM authorizes reduction of basis in open years using improperly deducted S corporation losses and deductions in excess of basis from closed years.

*The guidance contained in IRS TAM 200619021 is persuasive authority and governs in interpreting California tax law.*

The FTB previously communicated that the guidance contained in federal rulings dealing with the IRC are persuasive authority in interpreting the California statute and govern when federal law and California law are the same.[8] Conversely, federal rulings are not persuasive authority when: (1) The related RTC section is substantively different than the federal statute; (2) the RTC conforms to an IRC section that is modified after the California specified conformity date; or (3) the federal administrative guidance conflicts with California statutes or regulations.[9] As California adopted the federal law applicable to S corporation shareholders concerning pass-through of income and losses and basis calculations, California law is the same as federal law in this area. Additionally, neither the portions of RTC sections 23800.5 through 23813 that differ from federal law relating to S corporations—nor modifications to the IRC subsequent to the conformity date—are relevant to the pass-through of S corporation items of income, losses, deductions, and credits, and adjustments to shareholder basis. Further, there is no current federal guidance that conflicts with California statutes or regulations dealing with S corporation items of income, losses, deductions, and credits, and adjustments to shareholder basis. Therefore, IRS guidance, including the guidance contained in IRS

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[5] IRC section 1367(a).
[6] IRC section 1367(a)(2).
[7] See IRC sections 1366(d)(1)–(2) (The limitation on losses and deductions under IRC section 1366(d)(1) must be allocated among the shareholder's pro rata share of each loss or deduction. See also Treas. Reg. section 1.1366-2(a)(5).)
[8] FTB Information Letter 2010-5, citing: *J.H. McKnight Ranch, Inc. v. Franchise Tax Bd.* (2003) 110 Cal.App.4th 978, 984, fn. 1.
[9] FTB Information Letter 2010-5.

TAM 200619021, is persuasive authority interpreting S corporation pass-through income and losses and shareholder basis, and may govern in the interpretation of these conforming California statutes.

Accordingly, if a shareholder deducts losses in excess of the shareholder's basis in the S corporation in a closed year, then, in a subsequent open year, the shareholder's basis in the S corporation must be computed using the deducted losses in excess of basis from the closed year. As detailed in IRS TAM 200619021, the excess loss claimed in the closed year must be held as a separate amount in the IRC section 1366(d)(2) suspense account. The amount of excess losses claimed in closed years are then used to reduce the shareholder's basis starting in the first open year.

Finally, IRS TAM 200619021 does not address the situation of distributions in excess of basis in a closed year.

This Technical Advice Memorandum supersedes prior guidance in FTB TAM 20030305 to the extent of any conflict.

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