9.0 SHAREHOLDER BASIS

9.1 IMPORTANCE OF COMPUTING SHAREHOLDER BASIS

The amount of a shareholder's basis in an S corporation is important not only for purposes of determining gain or loss if the stock or debt is disposed of in a taxable sale or exchange, but also because it limits the amount of the shareholder's share of the corporation's loss deductions and other deductions that can be taken into account in computing the shareholder's individual tax liability. (Internal Revenue Code (IRC) Section 1366(d); California Revenue and Taxation Code (R&TC) Sections 23802.5 and 17087.5)

The following are also important in computing the amount of 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 S Corporation Manual Section 9.0 Shareholder Basis and S Corporation Manual Section 8.0 Distributions/Accumulated Adjustments Account (AAA) are simplified. They have not been computed on a per day, per share basis as in the Treasury Regulations (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

Before selecting the shareholder basis issue, it is important that the auditor obtains the S corporation's and shareholder's tax returns for the prior taxable years and current taxable year. The tax returns need to be analyzed for the amount of income, losses, deductions, and distributions being passed through from the S corporation (Schedule K) to the shareholder (Schedule K-1). Distributions not includible in a shareholder's income reduce stock basis. The items reported on the Schedule K-1 should be reconciled to the shareholder's tax return.

Pass through income items required to be included in gross income on the shareholder's income tax return increase stock basis only to the extent of the amounts shown on the return. If any amount is increased or decreased in a redetermination of a shareholder's liability, basis will be increased or decreased accordingly. (IRC Section 1367(b)(1)).

Example A

Shareholder A owns 100% of a California S corporation. His/Her Schedule K-1 for taxable year 2015 shows the following items:

Ordinary income	$1,000,000
Distributions	(300,000)
IRC Section 1231 Loss	(500,000)

The auditor needs to trace the items shown on Schedule K-1 to the shareholder's California personal tax return.

Adjusted basis as of 01/01/2015	$200,000
Ordinary income reported on Federal Schedule E	1,000,000
Distributions not reported on the tax return	(300,000)
IRC Section 1231 loss reported on Federal Schedule D-1	(500,000)
Shareholder A's adjusted basis as of 12/31/2015	$400,000

Based on the prior S corporation's tax returns, an auditor may compute the shareholder's adjusted basis for the beginning of a taxable year and use the income, loss, deductions, and distributions reported on the 2015 Schedule K-1 to calculate the shareholder's adjusted basis for the current year. In the example shown above, the shareholder has sufficient stock basis to recognize the current IRC Section 1231 loss of ($500,000). The shareholder also has sufficient stock basis to exclude the distribution from taxable income. The shareholder is allowed to recognize losses or deductions equal to her current distributive income items.

After analyzing the S corporation's and the shareholder's tax returns and computing the shareholder's adjusted basis for the current taxable year, an auditor will have information to decide if he/she should pursue the shareholder basis issue or not.

During scoping, it may be difficult to locate flow through losses generated by an S corporation on a shareholder's tax return. This is due to certain loss items limited by various limitations. Recognized losses and deductions may have already been limited due to shareholder basis, at-risk, passive activity losses, capital loss, and charitable contributions.

Example B

Shareholder A's Schedule K-1 for taxable year 2015 shows the following items:

Ordinary loss	($1,000,000)
Interest income	800,000

The auditor needs to trace the items shown on Schedule K-1 to the shareholder's California personal tax return.

Adjusted basis as of 01/01/2015	$0
Ordinary loss reported on Schedule E	(1,000,000)
Interest income reported on Schedule B	800,000
Adjusted basis as of 12/31/2015	$0

The aggregate amount of losses and deductions are not allowed to exceed a shareholder's basis in stock or debt of an S corporation. (IRC Section 1366(d)(1)) The basis of a shareholder's stock in an S corporation is not allowed to be decreased below zero by distributions, losses, deductions, nondeductible expenses, and deduction for depletion of oil and gas property. (IRC Section 1367(a)(2))

In this example, the shareholder is allowed to recognize ($800,000) of the ordinary loss, which is equal to the shareholder's current distributive income of $800,000 reported on his/her tax return. Since Shareholder A recognized on his/her 2015 tax return a net ordinary loss of ($200,000) in excess of her stock basis, an auditor will be able to adjust Shareholder A's tax return to disallow the excess net ordinary loss recognized. However, IRC Section 1366(d)(2)(A) allows an S corporation's shareholder any loss or deduction, which couldn't be deducted by the shareholder in the year it arose because of lack of basis to be treated as arising in the succeeding tax year with respect to that shareholder. Therefore, in this example, Shareholder A will be allowed to carry over the net ordinary loss of ($200,000) to the subsequent taxable year and will be able to recognize the loss if his/her distributed income items exceed his/her losses and deductions.

The auditor will compute the shareholder's basis as follows:

Adjusted basis as of 01/01/2015	$0
Interest income reported on Schedule B	$800,000
Ordinary loss allowed to be reported on Schedule E	($800,000)
Adjusted stock basis as of 12/31/2015	0
Carryover net ordinary loss to subsequent taxable years	($200,000)

9.3 INITIAL STOCK BASIS

Subchapter C provisions are applied to determine initial stock basis in an S corporation where there are no such provisions under subchapter S. (IRC Sections 1011 and 1012)

For your convenience, a list of general rules follows:

How Stock is Acquired	How Stock 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 Section 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 Section 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 Section 1015) Suspended passive activity losses can increase the basis of a gift. (IRC Section 469(j)(6))
Inheritance	The basis of inherited stock is its fair market value at the date of death or an alternate valuation date, if such an election is made. (IRC Section 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. Section 1.61-2(d)(2)(i))

9.4 ITEMS AFFECTING SHAREHOLDER BASIS

The basis adjustment rules under IRC Section 1367 are similar to the partnership rules under IRC Section 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 Section 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	Schedule K-1: • Rental income, real estate and other • Interest and dividend income • Royalties • Capital gains • Other portfolio income • IRC Section 1231 gain • Tax-exempt income • Other income • Cancelation of Indebtedness (COD) Income incurred on or before 12/31/02 (Refer to 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 Section 1367(b)(1))

a. Tax-Exempt Income

The general rule of IRC Section 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 Section 108 COD Income

- Discharge of Indebtedness Occurring after December 31, 2001

Where the discharge of an S corporation's debt results in COD income to the corporation passed through to the shareholders, the shareholders can use their share of this income to increase their basis. (*Alpert v. U.S.*, 99 AFTR 2d 2007-1788 (481 F. 3d 404)) But to the extent that the COD income is excluded from the S corporation's income because the corporation is in bankruptcy or is insolvent, the shareholders' stock bases are not increased. (IRC Section 108(d)(7)(A); Joint Committee on taxation, Technical Explanation of the Job Creation and Worker Assistance Act of 2002 (JCX-12-02), 3/6/2002, p. 29.)

An S corporation passes through its items of income and loss to its shareholders. Each shareholder takes into account separately his or her pro rata share of these items on their individual income tax returns. (Treas. Reg. Section 1.1366-1(a)) To prevent double taxation of these items, each shareholder's basis in the stock of the S corporation is increased by the amount included in income (including tax-exempt income) and is decreased by the amount of any losses (including nondeductible losses) taken into account.

In 2001, the United States Supreme Court ruled in the case of *Gitlitz v. Commissioner*, 87 AFTR 2d 2001-417 (531 U.S. 206) (2001), that, under current law, income from the discharge of indebtedness of an S corporation that is excluded from income was allowed to be treated as an item of income which increased the basis of a shareholder's stock in the S corporation and allowed the suspended corporate loss to pass through to a shareholder. Thus, under the decision, an S corporation shareholder was allowed to deduct a loss for tax purposes that it did not economically incur.

However, in response to the decision in *Gitlitz v. Commissioner*, Congress amended IRC Section 108 to provide that income from the discharge of indebtedness of an S corporation that is excluded from the S corporation's income is not taken into account as an item of income by any shareholder and thus does not increase the basis of any shareholder's stock in the corporation. (IRC Section 108(d)(7)(A); Joint Committee on Taxation, Technical Explanation of the Job Creation and Worker Assistance Act of 2002 (JCX-12-02), 3/6/2002, p. 29.)

California conformed to the federal change by enacting Assembly Bill (AB) 1122. The effective date of the state's conformity is for discharges of indebtedness occurring after December 31, 2001.

With respect to COD income, a taxpayer is required to reduce tax attributes, such as net operating losses, certain carryovers, and basis in assets, to the extent of the excluded income. In the case of an S corporation, the eligibility for the exclusion and the attribute reduction are applied at the corporate level. For this purpose, a shareholder's suspended loss is treated as a tax attribute that is reduced. Thus, if the S corporation is in bankruptcy or is insolvent, any income from the discharge of indebtedness by a creditor of the S corporation is excluded from the corporation's income, and the S corporation reduces its tax attributes (including any suspended losses).

9.4.2 Pro Rata Distributive Share Items That Decrease Stock Basis

IRC Section 1367(a)(2)	Also Known As	Specific Loss/Deduction
(A) Distributions by the corporation that were not includible in the income of the shareholder by reason of IRC Section 1368.	Return of capital distributions	
(B) Items of loss or deduction, the separate treatment of which could	Separately stated items	Schedule K-1: Rental losses • Other real estate losses • Capital losses

affect the liability of any shareholder.		• Other losses • 179 deduction • Charitable contributions • Royalty income deduction • 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 Section 162(c) • Fines and penalties not deductible under IRC Section 162(f) • Expenses and interest relating to tax-exempt income under IRC Section 265 • Losses for which deduction is disallowed under IRC Section 267(a)(1) • Nondeductible portion of meals and entertainment expenses, under IRC Section 274 • Income taxes attributable to the corporation's operations as a C corporation • Wages that are nondeductible because of targeted jobs tax credit • Nondeductible life insurance premiums • Nondeductible franchise tax • The two-thirds portion of treble damages paid for violating antitrust laws not deductible under IRC Section 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 Section 613A(c)(11)(B).		

a. Charitable Contributions

The decrease in shareholder's basis in his or her S corporation stock by reason of a charitable contribution made by the S corporation is equal to the shareholder's pro rata share of the adjusted basis of the contributed property. (IRC Section 1367(a)(2))

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 Section 24424 and IRC Section 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, and other items are limited at the S corporation level for purposes of applying the 1.5 percent tax. Schedules K and K-1, however, should reflect 100 percent of income, loss, and deduction items generated currently by the S corporation.

Example C	**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 Section 1366(a)(1) provides that a shareholder of an S corporation shall take into account his/her pro rata share of the S corporation's items of income, loss, deduction, or credit for the S corporation's taxable year ending with or in the shareholder's taxable year. However, IRC Section 1366(d)(1) **limits** the amount of losses and deductions the shareholder may take into account for any taxable year to the **sum** of his/her adjusted basis in the stock of the S corporation, plus his/her adjusted basis in "any indebtedness of the S corporation to the shareholder." The Senate Report discussing IRC Section 1374 (the predecessor statute to IRC Section 1366) illustrates Congress's intent to limit the loss that a shareholder takes into account to that shareholder's investment in the corporation; that is, to the adjusted basis of the stock in the corporation owned by the shareholder and the adjusted basis of any indebtedness of the corporation to the shareholder. (Senate Report 1983, 85th Congress 2d Session 219-220 (1958) (1958-3 CB 922,1141))

9.5.1 Concept of Indebtedness

The following rules applied for debt between an S corporation and its shareholders (debt basis) resulting from transactions **before July 23, 2014**:

In order for indebtedness of an S corporation to be considered part of the shareholder's basis, it must run directly from the corporation to the shareholder in order to permit the losses and deductions passed through by the S corporation to reduce (not below zero) a shareholder's adjusted debt basis. (IRC Section 1366(d)(1)(B)) The loan must in fact have been made by the shareholder and not merely guaranteed by him/her. (*Prashker v. Commissioner*, 59 TC 172 (1972)) In order for a loan from a shareholder to an S corporation to increase the shareholder's basis, there had to be an actual economic outlay of money by the shareholder to the corporation.

Courts developed the actual economic outlay standard, which requires that shareholders be made "poorer in a material sense" to increase their bases of indebtedness. Some courts concluded that an S corporation shareholder was not poorer in a material sense if the shareholder borrowed funds from a related entity and then lent those funds to his S corporation. (See *Oren v. Commissioner*, 357 F.3d 854 (8th Cir. 2004)) A shareholder must make an actual economic outlay to increase basis in an S corporation, even if the shareholder has made a direct loan. (*Bergman v. United States*, 174 F.3d 928, (8th Cir 1999))

With respect to shareholder guarantees, a shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. S corporation shareholders may increase their basis of indebtedness only to the extent they actually perform under a guarantee. The Tax Court consistently has concluded that a taxpayer guarantor does not make an actual economic outlay until required to honor the guarantee. (*Underwood v. Commissioner*, 38 AFTR 2d 76-5476 (535 F.2d 309), (5th Cir. 1976))
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. The true form of the transaction has to be carefully examined.

Effective **July 23, 2014**, final regulations were issued that changed the rules for establishing basis of indebtedness of S corporations to their shareholders. Treasury Decision (TD) 9682 issued on August 11, 2014, contains final regulations relating to basis of indebtedness of S corporations to their shareholders. The final regulations provide that S corporation shareholders increase their basis of indebtedness of the S corporation to the shareholder only if the indebtedness is bona fide. The final regulations affect shareholders of S corporations.

The following rules apply to debts between an S corporation and its shareholders (debt basis) resulting from transactions on or **after July 23, 2014**:

The final regulations provide that basis of any indebtedness of the S corporation to the shareholder means the shareholder's adjusted basis (as defined in Treas. Reg. Section 1.1011-1 and as specifically provided under IRC Section 1367(b)(2)) in any bona fide indebtedness (the bona fide standard) of the S corporation that runs directly to the shareholder. Whether indebtedness is bona fide indebtedness to a shareholder is determined under general federal tax principles and depends upon all of the facts and circumstances. (Treas. Reg. Section 1.1366-2(a)(2)(i)) Also, the proposed regulations issued in 2012 provided that the "actual economic outlay" standard no longer applied. TD 9682 states that the final regulations provide that basis of indebtedness of the S corporation to the shareholder means the shareholder’s adjusted basis in any bona fide indebtedness of the S corporation that runs directly to the shareholder. The Secretary has stated that "S corporations and their shareholders may rely on Treas. Reg. Section 1.1366-2(a)(2) with respect to indebtedness resulting from any transaction that occurred in a year for which the period of limitations on the assessment of tax has not expired before July 23, 2014." (Treas. Reg. Section 1.1366-5(b))

However, in *Meruelo v. Commissioner*, TC Memo 2018-16, the taxpayer claimed that under the final regulations issued in 2014 he no longer needed to support the actual economic outlay standard to obtain increased debt basis in his S corporation. The Tax Court disagreed with the taxpayer's interpretation of the regulation.

The Tax Court explains that in their view it does not matter whether (or to what extent) the new regulation applies because the outcome would be the same in either event. The test forth in the new regulation limiting basis to "bona fide indebtedness of the S corporation that runs directly to the shareholder" is the same test set forth in prior case law. (for example, *Hitchins v. Commissioner*, 103 TC 711 and *Prashker v. Commissioner*, 59 TC 172) These two court cases explain that "there must be a debt running directly to the shareholder in order to permit the deduction of a corporate net operating loss."

Furthermore, the Tax Court explains the new regulation provides that the existence of bona fide indebtedness shall be determined "under general federal tax principles." The "actual economic outlay" standard is a general tax principle that the Tax Court has applied, in numerous cases, to determine whether a shareholder has made a bona fide loan that gives rise to an actual investment in the corporation. (*Hitchins*, supra, *Ruckriegel v. Commissioner*, TC Memo 2006-78 and *Oren v. Commissioner*, TC Memo 2002-172) And principles developed in other tax contexts, requiring that a corporation's indebtedness to a shareholder be genuine and reflect economic realty, apply with equal force for purposes of IRC Section 1366(d)(1). (*Geftman v. Commissioner*, 154 F. 3d 61 (3d Cir. 1998)

The Tax Court held that the controlling test under prior case law, as under the new regulation, dictates that basis in an S corporation's debt requires proof of "bona fide indebtedness of the S corporation that runs directly to the shareholder." (Treas. Reg. Section 1.1366-2(a)(2)(i)) Requiring that the shareholder have made an "actual economic outlay" is a general tax principle that may be employed under the new regulation, as it was applied under prior case law, to determine whether this test (the bona fide standard) has been met. As a result, the Tax Court stated there is no need to decide the precise extent to which the new regulation applies to the taxpayer's transactions at issue.

Therefore, the Tax Court ruled that the taxpayer (shareholder) didn't receive additional basis in his S corporation because it was the related corporations that transferred funds to the S corporation. The Court held that the taxpayer made no "actual economic outlay" toward any of the advances the related entities made to the S corporation. Also, the Court held that on the basis of all the facts and circumstances, the taxpayer did not establishthe existence of bona fide indebtedness running from the S corporation directly to the taxpayer for the back-to-back loans claimed. The Court also held that the related entities that supplied funds to the S corporation were not the taxpayer's "Incorporated Pocketbook."

Currently, based on *Meruelo*, the "actual economic outlay" standard is a general tax principle that is applicable in determining whether the bona fide indebtedness standard has been met.

With respect to shareholder guarantees, the final regulation retains the economic outlay standard by adopting the rule that S corporation shareholders may increase their basis of indebtedness only the extent they actually perform under a guarantee. When a shareholder makes a payment on bona fide indebtedness of the S corporation for which the shareholder has acted as guarantor or in a similar capacity, then the shareholder may increase the shareholder's basis of indebtedness to the extent of that payment. (Treas. Reg. Section 1.1366-2(a)(2)(ii))

According to Treas. Reg. Section 1.1366-2(a)(2)(iii), the following examples illustrate the provisions of paragraph (a)(2)(i) and (ii) of the final regulation:

Example (1) - **Shareholder loan transaction**. A is the sole shareholder of S, an S corporation. S received a loan from A. Whether the loan from A to S constitutes bona fide indebtedness from S to A is determined under general federal tax principles and depends upon all of the facts and circumstances. If the loan constitutes bona fide indebtedness from S to A, A's loan to S increases A's basis of indebtedness. The same result applies if A made the loan to S through an entity that is disregarded as an entity separate from A. (See Treas. Reg. Section 1.1366-2-(a)(2)(i))

Example (2) - **Back-to-back loan transaction.** A is the sole shareholder of two S corporations, S1 and S2. S1 loaned $200,000 to A. A then loaned $200,000 to S2. Whether the loan from A to S2 constitutes bona fide indebtedness from S2 to A is determined under general federal tax principles and depends on all of the facts and circumstances. If A's loan to S2 constitutes bona fide indebtedness from S2 to A, A's back-to-back loan increases A's basis of indebtedness in S2. (See Treas. Reg. Section 1.1366-2-(a)(2)(i))

Example (3) - **Loan restructuring through distributions.** A is the sole shareholder of two S corporations, S1 and S2. In May 2015, S1 made a loan to S2. In December 2015, S1 assigned its creditor position in the note to A by making a distribution of the note to A. Under local law, after S1 distributed the note to A, S2 was relieved of its liability to S1 and was directly liable to A. Whether S2 is indebted to A rather than S1 is determined under general federal tax law principles and depends upon all of the facts and circumstances. If the note constitutes bona fide indebtedness from S2 to A, the note increases A's basis of indebtedness in S2. (See Treas. Reg. Section 1.1366-2-(a)(2)(i); Revenue Ruling 75-144 (1975-1 CB 277); *Gilday v. Commissioner*, TC Memo. 1982-242)

Example (4) - **Guarantee**. A is a shareholder of S, an S corporation. In 2015, S received a loan from Bank. Bank required A's guarantee as a condition of making the loan to S. Beginning in 2016, S could no longer make payments on the loan and A made payments directly to Bank from A's personal funds until the loan obligation was satisfied. For each payment A made on the note, A obtains basis of indebtedness. Thus, A's basis of indebtedness is increased during 2016 to the extent of A's payments to Bank pursuant to the guarantee agreement. (See Treas. Reg. Section 1.1366-2-(a)(2)(ii)) In this example, the actual economic outlay standard must be applied.

T.D. 9682 mentions the "circular flow of funds" transactions that include a restructuring of a loan originally made by an S corporation owned by the shareholder to another S corporation owned by that shareholder. For example, the loan is restructured by one of two alternatives: (1) S1 lends money to the shareholder, the shareholder lends that money to S2, and S2 uses that money to repay S1; or (2) S2 repays S1, S1 lends money to the shareholder, and the shareholder lends that money back to S2. It states a loan originating between two related entities that is restructured to be from the S corporation to the shareholder shows that the debt need not originate between the S corporation and its shareholder, provided that the resulting debt running between the S corporation and the shareholder is bona fide. However, the Treasury Department and the IRS are aware of cases involving Circular Flow of Funds that do not result in bona fide indebtedness. (See *Oren v. Commissioner*, 357 F.3d 854 (8th Cir. 2004) and *Kerzner v. Commissioner*, TC Memo. 2009-76) Whether a restructuring results in bona fide indebtedness depends on the facts and circumstances.

Bona Fide Indebtedness Factors

In order for a loan to increase a shareholder's debt basis, the shareholder must be the creditor and the loan must be bona fide. Whether a debt is bona fide is a facts and circumstances determination. The weight given to each factor varies depending upon the facts of the case. Case law describes factors that include, but are not limited to whether:

1. There is a written instrument.
2. There is a stated interest rate.
3. There is a maturity date.
4. The debt is enforceable under state law.
5. Expectation of repayment is reasonable.
6. The creditor has remedies upon default (security interest or the position of the lender with respect to other creditors).
7. Repayments were made or the parties complied with the term of the agreement.

Many court cases address what constitutes bona fide indebtedness. Most Circuit Courts of Appeal list factors used in making this determination. In analyzing whether there is bona fide indebtedness, consider the factors used by the Circuit Court controlling the shareholder's case. Below is a list of cases by Circuit Court. For additional factors, see the Service Notice 94-47.

- *Crowley v. Commissioner*, 962 F.2d 1077 (1st Cir. 1992) – 11 bona fide indebtedness factors
- *Fin Hay Realty Co. v. U.S.*, 398 F.2d 694 (3rd Cir. 1968) – 16 bona fide indebtedness factors
- *Slappey Drive Industrial Park v. U.S.*, 561 F.2d 572 (5th Cir. 1977) – 13 bona fide indebtedness factors
- *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625 (6th Cir. 1986) – 11 bona fide indebtedness factors
- *Busch v. Commissioner*, 728 F.2d 945 (7th Cir. 1984) – 7 bona fide indebtedness factors
- *In re Uneco v. U.S.*, 532 F.2d 1204 (8th Cir. 1976) – 13 bona fide indebtedness factors
- *A.R. Lantz Co. v. U.S.*, 424 F.2d 1330 (9th Cir. 1970) – 11 bona fide indebtedness factors
- *Williams v. Commissioner*, 627 F.2d 1032 (10th Cir. 1980) – 8 bona fide indebtedness
- *Lane v. U.S.*, 742 F.2d 1311 (11th Cir. 1984) 13 bona fide indebtedness factors

S Corporation Debt Owed Directly to Shareholder

There is no bright-line test to determine if the S corporation's bona fide debt is owed directly to the shareholder. As stated in the regulations, whether there is bona fide debt between the S corporation and the shareholder is determined under general federal tax principles and depends upon all of the facts and circumstances. When analyzing the debtor-creditor relationship, consider if:

- The proceeds came from the shareholder versus a third party.
- The intent of the S corporation is to repay the shareholder.

In order for a loan to increase the shareholder's debt basis, the shareholder must be the creditor and the loan must be bona fide. If a loan is from a third party lender, then the third party lender is the creditor, not the shareholder, and the shareholder's debt basis is not increased.

Loan Guarantees

Shareholders often guarantee the corporation's third party debt. The corporation's name is on the loan, with the shareholder signing as a guarantor in case the S corporation defaults. In these cases, the guarantee itself does not create debt basis for the shareholder because there is no loan between the shareholder and the corporation. A shareholder is not allowed debt basis for merely guaranteeing the corporation's debt. However, when a shareholder repays a debt of the S corporation for which the shareholder has acted as a guarantor or in a similar capacity, the shareholder may increase debt basis to the extent of that repayment. It is important to note that the final regulations (effective July 23, 2014) do not affect the prior judicial determinations related to shareholders guaranteeing S corporation debt. These well-established doctrines are applicable before and after the final regulations. (Treas. Reg. Section 1.1366-2(a)(2)(ii))

Judgment on Default of Loan Guarantee – No Basis

When an S corporation defaults as the primary obligor on its loan obligation and a judgment is imposed on the shareholder as a result of a guarantee, the judgment does not create a debt between the shareholder and the S corporation. Therefore, a judgment on default does not create debt basis. (*Montgomery v. Commissioner*, TC Memo. 2013-151 and *Phillips v. Commissioner*, TC Memo 2017-61)

Co-Making or Co-Borrowers

In a co-making or co-borrowing loan transaction, a third-party lender requires both the S corporation and the shareholder to sign the loan as the borrowers. Therefore, both the S corporation and the shareholder are liable to the third-party lender. A shareholder's debt basis is not increased in a co-making or co-borrowing situation. This is because the co-borrowed amount is not debt the S corporation owes to the shareholder; rather both the shareholder and the S corporation owe the third-party lender. Since the S corporation and the shareholder have not entered into debtor-creditor relationship, the shareholder's debt basis is not increased. Court cases addressing co-borrowing should be considered since this issue is not specifically addressed in the regulations. (*Salem v. Commissioner*, TC Memo.

1998-63 (1998) aff'd, 196 F 3d 1260 (11th Cir. 1999) and *Nigh v. Commissioner*, TC Memo. 1990-349)

9.5.2 Summary of Administrative Rulings and Case Law

Administrative rulings and case law support 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 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

The IRS and courts have developed a rule that a shareholder has no basis in debt for purposes of IRC Section 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 the contract of guaranty does the debtor's liability to the creditor become indebtedness to the guarantor. In this regard, TD 9682 explains that "the final regulations [i.e., 26 CFR 1.1366-2] retain the economic outlay standard by adopting the rule . . . that S corporation shareholders may increase their basis indebtedness only to the extent they actually perform under a guarantee."

- Revenue Ruling 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 guarantee 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 guarantee, the corporation became indebted to the shareholder under the doctrine of subrogation.

- Revenue Ruling 71-288, 1971-2 CB 319

  Clarified Revenue Ruling 70-50 by stating that the indebtedness of the corporation to the shareholder arising in the third year upon payment by the shareholder under his guarantee 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.

- Revenue Ruling 75-144, 1975-1 CB 277

  The facts are the same as in Revenue Ruling. 70-50, except that instead of actually paying money to the bank in satisfaction of his guarantee, 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 guarantee 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 Section 1374(c)(2)(B), (the predecessor statute to IRC Section 1366).

  The court held that "no form of indirect borrowing, may it be a guaranty, surety, accommodation or co-making, or otherwise gives rise to indebtedness from the corporation to the shareholders **until and unless the shareholders pay part or all of the obligation**." (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, 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 found 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 as a result of the guarantees.

- *Harrington vs. United States*, 55 AFTR 2d 85-769, 605 F Supp 53, (DC DE 1985)

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 the Raynor case.

Absent actual economic outlay, indirect borrowing cannot give a shareholder basis in the debt. Guarantors, sureties, accommodation parties, and co-makers 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. Thus, if a shareholder is an accommodation party and has made no economic outlay, then the shareholder is not entitled to any basis in the debt. (See also *Reser v. Commissioner*, 79 AFTR 2d 97-2743 (112 F.3d 1258), (5th Cir. 1997) and *Grojean v. Commissioner*, 87 AFTR 2d 2001-1673 (248 F.3d 572), (7th Cir. 2001))

- Gilday v. Commissioner, TC Memo. 1982-242

Shareholders of an S corporation gave their personal notes to a bank in cancellation of the S corporation's notes. The substitution of the shareholders' notes for that of the corporation's canceled notes created valid debt from the corporation to the shareholders and thus increased the shareholders' debt basis in the corporation.

Note: Subsequent to an examination, the corporation's debt may be restructured in order to make the shareholder personally liable for the third-party debt. Assuming the restructuring creates a bona fide loan from shareholder to the S corporation, the shareholder's debt basis is increased in the year of restructuring, but not in the year of the audit.

- *Leavitt, Estate of Daniel v. Commissioner*, 63 AFTR 2d 89-1437 (875 F. 2d 420), (4th Cir. 1989)

The Court of Appeals for the Fourth Circuit, affirming the Tax Court, found that the taxpayers had no bases in the loan from a bank to an S corporation where the taxpayers had personally guaranteed the loan. 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 shareholders 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 shareholders 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 held that the taxpayers' position was 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 loan.

- *Harris v. United States*, 66 AFTR 2d 90-5104 (902 F.2d 439), (5th Cir. 1990)

  The taxpayers formed Harmar, an S corporation, which was initially capitalized by its two equal shareholders, each of whom contributed $1,000 and each loaned Harmar $47,500 for operating expenses. Harmar obtained a $700,000 loan from Hibernia National Bank to purchase a movie theater by executing two notes in the amount of $350,000 each. 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 of $700,000 in favor of Hibernia. For tax year 1982, Harmar reported a net operating loss of $104,013 and the taxpayers each claimed half of the loss as a deduction for that year. On audit, the IRS disallowed a portion of the loss deductions finding that each shareholder had a basis of $1,000 in Harmar stock and a basis of $47,500 in Harmar indebtedness. The taxpayers sought to have the court recharacterize the transaction as a $700,000 loan to them, which they subsequently contributed to Harmar's account. They supported their position with a bank officer's testimony that the bank looked primarily to the shareholders for repayment.

  The court made the following findings: Harmar received the interest notices, made all loan payments, and deducted the interest payments on its income tax returns. The Harmar financial statements for tax year ending December 31, 1986, were the first to show any contributed capital attributable to the Hibernia loan. Harmar's 1982 return showed no loan repayments to the taxpayers, 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 reported 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 taxpayers to Harmar, held that no economic outlay had been made.

- *Nigh v. Commissioner*, TC Memo 1990-349 (1990)

  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 shareholders argued that as co-makers of the loans they had in substance borrowed funds and made contributions to capital that increased their bases in the corporation's stock.

  The court held that "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." (Citing *Estate of Leavitt v. Commissioner*, 63 AFTR 2d 89-1437 (875 F.2d 420), (4th Cir 1989)) Accordingly, the court rejected the shareholders' argument that by acting as co-makers on the loans they made contributions to the corporation's capital that increased their bases.

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

The taxpayer was the sole shareholder of Don C. Reser, P.C. (DRPC), an S corporation. For taxable years 1987 and 1988, the taxpayer deducted losses passed through by DRPC on his individual tax returns. The IRS determined that the taxpayer had no evidence to support his basis in DRPC and disallowed the deductions. The main issue in this case is whether the taxpayer's basis in DRPC should be increased to reflect amounts lent from North Frost Bank of San Antonio (Frost Bank) or from the taxpayer to DRPC. It must be proven that the taxpayer has made an economic outlay of some kind. (*Harris v. United States*, 902 F.2d 439, 443 (66 AFTR 2d 90-5104), (5th Cir. 1990)) A mere guaranty will not constitute the required economic outlay until such time that the shareholder is actually called upon to pay all or part of the obligation. (*Estate of Leavitt v. Commissioner*, 63 AFTR 2d 89-1437, (875 F. 2d 420), (4th Cir. 1989))

DRPC was originally capitalized by Don Reser (shareholder) 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 North 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. North 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.

Based on the facts presented, the Court found that there was no legitimate debt between the taxpayer and DRPC. The evidence provided did not support that there was a debt owed by DRPC to taxpayer and one from taxpayer to Frost Bank.

In this case, there is one factor different than in the Harrington case, 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 v. Commissioner*, TC Memo 1998-63 (1998)

  For taxable year 1990, the taxpayer deducted a loss passed through from his S corporation, Salem, Saxon & Nielsen, P.A. (SS&N), on his individual tax return. The taxpayer, Mr. Salem, was the primary shareholder in the S corporation. The IRS disallowed the deduction.

  An accountant advised the shareholders of the 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 one 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 Section 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*, 66 AFTR 2d 90-5104 (902 F. 2d 439), (5th Cir. 1990) and *Estate of Leavitt v. Commissioner*, 63 AFTR 2d 89-1437 (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) The court also found that after the shareholders signed the notes as co-makers, the bank continued to look primarily to the S corporation for repayment. Therefore, regardless of the form of the notes, the debts in substance continued to be loans from the bank to the S corporation. As a result, the Court disallowed the loss claimed by the taxpayer.

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

- Blum, Peter v. Commissioner, 59 TC 436 (1972)
- Perry, William v. Commissioner, 47 TC 159 (1966)
- Thompson, Mark v. Commissioner, TC Memo 1977-35 (1977)
- Brown, J.W. v. Commissioner, TC Memo 1979-220 (1979)
- *Brown, Frederick v. Commissioner*, 52 AFTR 2d 83-5080 (706 F.2d 755), (6th Cir. 1983)
- Bader, Lewis v. Commissioner, TC Memo 1987-30 (1987)

Special Note: *Selfe v. U.S.*, 57 AFTR 2d 86-464 (778 F.2d 769), (11th Cir. 1985)

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*, 29 AFTR 2d 72-1408, (5th Cir. 1972)) 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*, 63 AFTR 2d 89-1437 (875 F.2d 420), (4 Cir. 1989), 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*, 54 AFTR 2d 84-6098 (742 F. 2d 1311), (11th Circuit 1984), 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 its 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

In order for a loan to increase a shareholder's debt basis, the shareholder must be the creditor and the loan must be bona fide (the bona fide standard). Whether a debt is bona fide is a facts and circumstances determination. The weight given to each factor varies depending upon the facts of the case.

Therefore, loan transactions such as shareholder(s) loan(s), back-to-back loans, loan restructuring through distributions or circular flow of funds loans require that the loan made by the shareholder to the S corporation constitutes a bona fide indebtedness from the S corporation directly to the shareholder. The auditor must determine if the loan is bona fide debt based on the general federal tax principles.

The Tax Court’s opinion in *Underwood v. Commissioner*, 63 TC 468 (1975), 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 (1975)	Substitution of notes
Private Letter Ruling 9403003, September 29,1993 (not citable)	Substitution of notes
Wilson v. Commissioner, TC Memo 1991-544 (1991)	Distribution of note
Shebester v. Commissioner, TC Memo 1987-246 (1987)	Journal entries

Griffith v. Commissioner, TC Memo 1988-445 (1988)	Journal entries
Burnstein, Sanford v. Commissioner, TC Memo 1984-74 (1984)	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 a 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 Section 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 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 Section 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, 89 AFTR 2d 2002-383, (3rd Cir. 2002) and *Yates v. Commissioner*, TC Memo 2001-280 (2001))

In *Culnen v. Commissioner, supra,* 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. Also, in *Culnen v. Commissioner, 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*, TC Memo 2001-280 (2001), reached a similar result apparently based on the same reasoning.

As a result 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 Section 1366(a) provides that an S corporation shareholder may deduct his pro rata share of the S corporation's net operating loss. However, IRC Section 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 shareholder's basis (IRC Section1366(d)(1)). (See *Frankel v. Commissioner* 61 TC 343 (1973) (loans from partnership to S corporation), *Prashker v. Commissioner* 59 TC 172 (1972) (loan from estate to S corporation), and *Burnstein, et al v. Commissioner*, TC Memo 1984-74 (1984) (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." (*William H. Perry v. Commissioner*, 27 AFTR 2d 71-1464, (8th Cir. 1971), 54 TC 1293 (1970))

- 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 (1972)) 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*, 83 AFTR 2d 99-1882 (174 F.3d 928), (8th Cir. 1999))

- 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*, TC Memo 1982-242 (1982), shareholders of an S corporation gave their personal notes to a bank in cancelation of the S corporation's notes. The substitution of the shareholders' notes for that of the corporation's canceled notes created valid debt from the corporation to the shareholders and thus increased the shareholders' debt basis in the corporation.

  However, not all loan restructuring transactions result in an "actual economic outlay." In *Underwood v. Commissioner*, 38 AFTR 2d 76-5476 (535, F. 2d 309), (5th Cir. 1976), 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."

  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 (1991); *LeRoy Griffith v. Commissioner*, TC Memo. 1988-445 (1988); and *Bergman v. United States*, 83 AFTR 2d 99-1882 (174 F.3d 928), (8th Cir. 1999).

- Loan to S Corporation Restructured as Shareholder "Contribution"

  In *Harris v. U.S.*, 66 AFTR 2d 90-5104 (902 F .2d 439), (5th Cir. 1990), 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.

- Distributions From One Entity and Loaned to the S Corporation

  In *Jerry L. Shebester v. Commissioner*, TC Memo 1987-246 (1987), 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 [the profitable corporation's] book 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 [the unprofitable corporation's] debt.”

  Distributed loans and then the “loan” to the S corporation were also seen in *Edward A. Wilson v. Commissioner*, TC Memo 1991-544 (1991).

Back-to-Back Loans and Related Party Debts

A back-to back loan occurs when a person borrows money from one party and then lends that money to another. Debt basis is allowed for back-to-back loans from related parties assuming a debtor-creditor relationship exists between the S corporation and the shareholder, with the S corporation being the debtor and the shareholder being the creditor (the bona fide standard). (Treas. Reg. Section 1.1366-2(a)(2)(iii))

Note: When dealing with related party back-to-back loans, it is important to see how both the entity lending the funds and the S corporation borrowing the funds booked the transaction on their financial statements. The shareholder may claim to have debt basis in the S corporation, yet the related entity's books reflect "Due from Affiliate" on its balance sheet.

If done properly, the S corporation should show a payable to the shareholder. This is reflected on line 18 of the Form 100S balance sheet, Loan from Shareholders. If, instead, the S corporation shows a payable to the related entity on its balance sheet, that is an indication that it may not be shareholder debt as the funds did not come from the shareholder and are not due to the shareholder. Do not simply rely on the S corporation's balance sheet when auditing this issue. Follow the flow of the transaction and determine how the transaction was recorded. Review the S corporation's general ledger and see which general ledger account(s) record the payable.

In addition, request a copy of any loan agreements evidencing the S corporation's payable. If the balance sheet shows a Loan from Shareholder, but the loan agreement shows it is due to another party, the shareholder may not be the creditor. If the shareholder is in fact not the creditor, then the loan amount does not increase the shareholder's debt basis. If the related entity shows a receivable due from the S corporation, that is a key indicator that the related entity is the creditor, and not the shareholder. In order for the Loan from Shareholder to be respected on the S corporation's books, the related entity's books and records must show that the shareholder received the funds either through a loan or a distribution. Review the entire transaction and confirm that both the related party and the S corporation reflect the transaction consistently.

Distributions from a Related Entity to the Shareholder

A distribution from a related entity to the shareholder and then a loan from the shareholder to an S corporation may be sufficient to allow the shareholder debt basis. In *Maguire v. Commissioner,* TC Memo 2012-160, the shareholder owned two S corporations; one was profitable (Profitable Entity) and the other was in a loss situation (Loss Corporation). Loss Corporation borrowed funds from Profitable Entity; thus Profitable Entity carried a receivable owed by Loss Corporation on its balance sheet.

The shareholder was unable to claim pass-through losses from Loss Corporation, because the shareholder did not have sufficient basis. Consequently, the shareholder directed Profitable Entity to distribute the receivable from Loss Corporation to the shareholder, who then contributed it to Loss Corporation, effectively canceling the note.

The court held that the shareholder's stock basis in Loss Corporation was increased by the receivable contributed, which had been previously distributed to the shareholder from Profitable Entity. At the conclusion of the transaction, the shareholder's basis in Profitable Entity was reduced and his basis in Loss Corporation was increased.

On the other hand, if the shareholder personally kept the receivable, instead of contributing it to Loss Corporation, the corporation and the shareholder would have a debtor-creditor relationship. Assuming that the debt is bona fide, the shareholder's debt basis would increase by that amount. (Example 3 of Treas. Reg. Section 1.1366-2(a)(2)(iii)

Circular Flow of Funds

A circular flow of funds involves a series of transactions in which funds pass through entities or individuals and are ultimately returned to the originating entity. In other words, the funds circle back to the originator. If this occurs within a short timeframe, for example, over several days, it may be appropriate to develop facts concerning the business purpose and economic substance of the transactions to determine if they increase the shareholder's basis.

Historically, courts have ruled that circular flows of funds do not create shareholder debt basis. However, the summary of comments to the final regulations (T.D. 9682) states that the Treasury Department and the IRS recognize that under certain circular cash flows a corporation may become indebted to its shareholder which increases the shareholder's debt basis. Nonetheless, transactions that lack economic substance or transactions in which the shareholder is merely a conduit do not increase debt basis.

In *Oren v. Commissioner*, TC Memo 2002-172 357, the taxpayer (Mr. Oren) was advised by his tax advisers to restructure his financial investments in his four (Dart, Fleetline, HL and HS) S corporations so that he might receive the benefit of the ordinary loss deductions. The taxpayer followed the advice of the tax advisers and entered into a series of lending transactions for the purpose of increasing debt basis in his S corporations, HL and HS. The loan transactions were in the form of a "Circular flow of Funds."

For each year in December 1993, 1994, and 1995, Dart lent money to Mr. Oren, in turn, Mr. Oren lent the same amount of money to HL and then HL lent that same amount of money back to Dart. Similarly, Dart lent money to Mr. Oren, in turn, Mr. Oren lent the same amount of money to HS and then HS lent the same amount of money back to Dart. Demand notes were executed by all the parties in the transactions. With the exception of the note from HS to Mr. Oren, the taxpayer signed all the notes either in his individual capacity or as president of Dart or HL.

For 1993 through 1995, the taxpayer's financial statements did not reflect Mr. Oren's loan obligations to Dart or the loan obligations from HL and HS to Mr. Oren. The 1993 through 1995 combined balance sheets for the Dart companies did not reflect the loan obligations between Dart and Mr. Oren; Mr. Oren and HL; and HL and Dart.

For tax years 1994, 1995, and 1996, the payments of interest and repayments of loans between the parties were also made in a Circular Flow of Funds format.

For 1993, 1994, and 1995, the taxpayer deducted on his tax returns losses passed through from HL and HS. The IRS disallowed the losses for 1993 and 1994 and reduced the losses deducted for 1995 because the loans from Dart to Mr. Oren then to HL and then back to Dart did not create indebtedness. Also, the loans from Dart to Mr. Oren then to HS and then back to Dart did not create indebtedness.

The court made the following findings:

- The loan transactions were not reflected on the books and records of the S corporations or the taxpayer.
- The promissory notes did not have terms consistent with notes executed for the benefit of unrelated third parties, especially in the light of the size of the loans.

- The loans were unsecured and were in the form of notes due 375 days following demand.
- The taxpayer was not required to make repayment to Dart in all events.

The taxpayer claimed that a default on the part of Dart, HL, or HS on the various loan obligations could have triggered a chain reaction that would have forced the taxpayer to pay Dart out of his own assets. The court disagreed with the taxpayer's characterization, finding that Dart was a financially stable and expanding company and that the taxpayer presented no evidence that Dart would have been unable to repay its loan obligations to HL and HS or that HL and HS would have been unable to pay their obligations. Thus, the court concluded that it was highly improbable that Dart would have made demand on the taxpayer to repay his loans from Dart because any demand on the taxpayer would have resulted in a demand by Mr. Oren of HL and HS. In addition, the court found any demands for repayment would have been futile because each party would have had equivalent rights of demand against other parties in the circular chain of obligations. The court held that the loans in this case were nothing more than a tripartite, interconnected arrangement that, as a practical matter, would not have given rise to an obligation on the part of the taxpayer to repay from his personal resources. The court also disagreed with the taxpayer that Dart's minority shareholders had the right to recover on the loans made from Dart to the taxpayer because Dart's minority shareholders were taxpayer's children. Therefore, the children would have not demand for repayment premature to the taxpayer's own wishes because Mr. Oren had exclusive control of all matters within the Dart companies. For those reasons, the court held that the loans were not bona fide debts.

The 8th Circuit Court of Appeals in *Oren v. Commissioner*, 357 F.3d 854 (8th Cir. 2004), affirmed the tax court's decision.

In *Kerzner v. Commissioner*, TC Memo 2009-76, the court held that the loans made by the taxpayers did not constitute bona fide debt. The taxpayers owned interests in a partnership (HCA) and an S corporation (HCI). For each year from 1986 to 2001, HCA lent money to the taxpayers and, in turn, the taxpayers lent identical amounts of money to HCI which paid the equivalent amounts in rent to HCA. The court found that the loan transactions were a circular flow of funds. For tax year 2001, the IRS disallowed the taxpayers' claimed loss deduction which was passed through by HCI because the IRS determined that the taxpayers lacked sufficient basis in the S corporation.

The terms of a Housing and Urban Development (HUD) loan entered into between HCA and a third-party lender, placed restrictions on HCA making loans to its related parties.

For each loan between HCA and the taxpayers and between the taxpayers and HCI, promissory notes were executed near the end of each calendar year and within a short time of each other. Each note included the total outstanding loan balance and, therefore, revised and superseded the loan notes issued in the prior year. Each note required no principal payments until the end of the following year. Most of these notes stated an interest rate, but the notes the taxpayer issued to HCA from 1996 through 1999 did not.

The HCA loans made to the taxpayers were recorded as "Other Current Assets" that were "Due from Partners" on HCA's balance sheet. The taxpayers' reported the interest income yearly on their Schedule K-1, and they deducted the related investment interest expense.

The loans from the taxpayers to HCI were reported on HCI's balance sheet as "Loans from Shareholder". HCI did not deduct accrued interest expense for tax purposes, and the taxpayers did not report accrued interest income as part of their gross income. With the exception of a $14,233 repayment of principal during the 1993 tax year by HCI to taxpayers, no payments of principal or interest were ever made on any of the notes. The taxpayers reclassified $453,098 of accrued interest on loans to HCI in 2001 as additional paid-in capital in HCI's accounting records. The taxpayers made the reclassification entry in response to HUD's request in connection with the HUD loan.

The court made the following findings:

- There was no real expectation that the taxpayers would repay HCA because the taxpayers exercised complete control over both HCA and HCI.
- There was no significant risk that taxpayers would themselves ever have to repay any portion of the HUD loan. The taxpayers were never primarily liable on the HUD loan.
- The fact that only one repayment was ever made in 16 years to the taxpayers from HCI further indicates the loans lacked substance.

The court explained the transfers between the taxpayers and HCI were not truly loans as the taxpayers reported no interest income and HCI claimed no interest deductions. With the exception of HCI's single repayment on principal in 1993, none of the parties ever made any payments on the loans. Because the court was unpersuaded that the taxpayers would ever have to repay the loans from HCA, the court determined that the loans were not bona fide indebtedness.

Loan from Shareholder – Asset Sale or Redemption of Stock

It is not uncommon for a shareholder to sell assets to his S corporation and report the gain on the sale under the installment method. Additionally, it is not uncommon for the corporation to redeem a shareholder's stock and issue a note to the shareholder in exchange for the stock. The installment method is an accounting method for reporting gains (not losses) from the sale of property when at least one payment is received in a tax year after the year of sale; that is, there are deferred payments.

Under the installment method, gain from the sale is prorated and recognized over the years in which payments are received. As a result, each payment received usually consists of interest, return of basis, and gain on the sale. The gain recognized each year is equal to the payments received during the year times the gross profit percentage.

If a sale qualifies for the installment method of reporting gain, the transaction is reported on Form 6252, *Installment Sale Income*, which is attached to the Form 540. In addition, the use of the installment method automatically applies unless the taxpayer elects out. The taxpayer elects out of the installment method by reporting all the gain as income in the year of sale. A taxpayer must make an election no later than the due date for filing the taxpayer's return (including extensions) for the year in which the sale occurs.

One of the reasons installment sales reporting was created was to relieve taxpayers from having to pay tax on the entire gain in the year of sale when in fact they had only received cash for a portion of the proceeds. Therefore, when the S corporation issues a note to the shareholder to purchase the asset, the S corporation and the shareholder **essentially enter**

into a debtor-creditor relationship, which may increase the shareholder's debt basis in the S corporation.

Under IRC Section 453B(b), the basis of an installment obligation equals the excess of the face value of the obligation (the remaining principal amount) over an amount equal to the income which would be returnable were the obligation satisfied in full (the remaining unreported gain). This results in the shareholder's basis in the note being equal to the shareholder's remaining basis in the property sold.

Example D

Jack is the sole shareholder of an S corporation. On July 14, 2015, Jack sells land with an adjusted basis of $250,000 to his S corporation for $1,000,000. At the date of sale, the S corporation gave Jack $100,000 in cash and a note receivable for $900,000. For tax year 12/2015, Jack reported the sale of land under the Installment Sale Method as follows:

Description	**Amount**	
Sales Price	$1,000,000	
Adjusted Basis of Land	250,000	
Gain on Sale	750,000	
Gross Profit Percentage	75.00%	
Amount Received - 12/2015	100,000	
Gross Profit Percentage	75.00%	
Reportable Gain	75,000	
Remaining Basis in Note	225,000	(250,000 - 25,000)
Alternate Method		
Remaining Face Amount of Note	900,000	(1,000,000 - 100,000)
Remaining Unrecognized Gain	675,000	(750,000 - 75,000)
Remaining Basis in Note	$225,000	

Jack's debt basis is equal to his remaining basis in the note receivable, which is $225,000. As a result, Jack can report flow through losses up to his debt basis of $225,000. Note: the outstanding balance of the note receivable, $900,000 is not Jack's basis in the note receivable since Jack has not reported the $675,000 (750,000 - 75,000) of deferred gain.

As the note receivable is repaid by the S corporation, Jack's basis in the note receivable will decrease. Also, the $75,000 reported gain does not increase Jack's debt basis as the gain is associated with Jack's gain for the sale of land to the S corporation. The $75,000 is not flow through income from the S corporation.

Once the note receivable's initial basis is established, Jack will have debt basis to report flow through S Corporation losses against. Claiming, any flow through losses against debt basis will reduce Jack's basis in the note receivable.

Single Member LLC Lends or Contributes Money to the S Corporation

Under the check-the-box provisions, a single member limited liability company (SMLLC) is automatically treated as a disregarded entity unless an election is made to be treated as a corporation. For tax purposes, a SMLLC entity is disregarded and its activity is treated as the individual owner's activity. Therefore, if the SMLLC lends money to the individual's S corporation, it is treated as if the individual personally lent the money. Assuming it is bona fide indebtedness, the loan creates debt basis for the shareholder. (IRC Section 1366(d)(1)(B) and Treas. Reg. Section 1.1366-2(a)(2)(iii) – Example 1)

- Transfers of Funds Between Entities

  Shareholders have structured the transaction as "loan" from a third party lender to the shareholders and then loan from the shareholders to the S corporation. Yet, the funds are transferred directly between the third party lender and the S corporation. In this situation, the underlying documents must be examined to determine the true nature of the transaction.

  In *Bolding v. Commissioner*, 80 AFTR 2d 97-5481 (117 F.3d 270), (5th Cir. 1997) 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*, TC Memo 1982-242 (1982). In that case, the S corporation issued notes payable to a bank with the shareholders as guarantors. Eight months later, the shareholders issued a note same amount to the bank and the bank cancelled the notes payable from the S corporation. During the following year, payments were made directly from the S corporation to the bank, but the court noted that to pay the shareholders and have the shareholders pay the bank would seem to be the utilization of fruitless steps.

- Restructure of related Demand Notes

  As previously mentioned, in *Underwood v. Commissioner*, 38 AFTR 2d 76-5476 (535 F.2d 309), (5th Cir. 1976), the Court concluded that the shareholders in 1967 merely exchanged demand notes between themselves and their wholly owned corporations; they advanced no funds to either the C corporation or S corporation. Neither at the time of the transaction, nor at any other time prior to or during 1969 was it clear that the shareholders would ever make a demand upon themselves, through the C corporation, for payment of their note. Therefore, as in the guaranty situation, until the shareholders actually paid their debt to the C corporation in 1970 the shareholders had made no additional investment in the S corporation that would increase their adjusted basis in an indebtedness of the S corporation to them within the meaning of IRC section 1374 (the predecessor statute to IRC Section 1366). Consequently, the court explained, the signing of shareholders note to the C corporation and the S corporation's note to the shareholders did not give the shareholders an adjusted basis in an indebtedness within the meaning of IRC section 1374(c)(B).

As the Court explained in *Perry v. Commissioner*, there has to be an "actual economic outlay" of the shareholder in question. The rule which the Court reached this interpretation is no more than a restatement of the well-settled maxim which requires that "Before any deduction is allowable there must have occurred some transaction which when fully consummated left the taxpayer (shareholder) poorer in a material sense."

e. Administrative Rulings and Court Decisions on Miscellaneous Qualifying / Non-qualifying Indebtedness

- Partnership Indebtedness

  Revenue Ruling 69-125, 1969-1 CB 207: Loans from a partnership controlled by shareholders of an S corporation to the S corporation are not debt owed directly to the shareholders and thus do not increase the shareholders' debt basis in the S corporation.

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

  Frankel v. Commissioner, 61 TC 343 (1973): 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 v. Commissioner, TC Memo 1995-191 (1995): Taxpayer, the sole shareholder of two S corporations, asserted that loans from S corporation 2 to S corporation 1 should be attributed to him for purposes of increasing his basis in S corporation 1 due to the fact that he was the sole shareholder of S corporation 2. The court held that the taxpayer could not ignore the corporate form in which he chose to do business as two separate S corporations and that S corporation 2 was not a shareholder in S corporation 1. Thus, the loans made to S corporation 1 could not be attributed to the taxpayer through S corporation 2, for purposes of increasing the taxpayer's basis in S corporation 1 and thereby giving him sufficient basis to recognize net operating losses flowing to him as a shareholder in S corporation 1.

- Shareholders of S Corporation Are Co-Makers or Jointly Liable on Note

  Charles A. Nigh v. Commissioner, TC Memo 1990-349 (1990) and *Albert D. Duke v. Commissioner*, TC Memo 1976-50 (1976): In each case, the taxpayers-shareholders were co-makers of the notes issued by the banks to their S corporation. The S corporation received the proceeds from the loans. Payments of principal and interest were made by the S corporation to the bank. None of the proceeds were treated as capital contributions on the S corporation's books. The shareholders treated the amount of the loans as increases to their bases in the S corporation and deducted net operating losses passed through by the S corporation.

The courts concluded that the shareholders, as co-makers of the notes, did not increase their bases in their S corporation stock. The courts found that the loans were made to the S corporation and not the shareholders and that there was no actual economic outlay by the shareholders. Therefore, the courts disallowed the shareholders' deductions of the net operating losses to the extent of the basis increases claimed by the shareholders.

- Note Given to Shareholder for Unpaid Salaries

  George W. Wise v. Commissioner, TC Memo 1971-38 (1971) and *Joe E. Borg v. Commissioner*, 50 TC 257 (1968): In each case, the S corporation issued a note to the shareholder for unpaid salaries. Since the shareholder reported on a cash basis, she did not report the note issued for unpaid salaries on her tax returns. The courts explained where a taxpayer had not previously reported, recognized, or even realized income, it cannot be said that she had basis for a note evidencing her right to receive such income at some time in the future. The performance of services, involving neither the realization of taxable income nor a capital outlay, is not the kind of cost that would be shown in a cash receipts and disbursements system of income accounting. Since the services performed by the shareholder had no cost within the meaning of IRC Section 1012, her notes for unpaid salary had a basis of zero, and therefore, added nothing to the adjusted basis for indebtedness for the purpose of computing the IRC Section 1374(c)(2) limitation on net operating loss deductions. Therefore, since the shareholder did not report on her tax return the amount of unpaid salaries, her adjusted debt basis in the S corporation was zero, and the net operating losses passed through by the S corporation were properly disallowed.

- Note held by trust in which shareholder was a remainderman.

  Robertson v. U.S., 32 AFTR 2d 73-5556, (DC-NV 1973): An S corporation passed through net operating losses to its shareholder. The shareholder deducted the losses on his tax return, but he had a zero stock and debt basis in the S corporation. The shareholder claimed a basis increase that allowed him to deduct the losses because the S corporation was indebted to him as evidenced by a promissory note held by his trust. The court explained that it was not enough to show that the shareholder's interest in the trust is property and a form of ownership. Instead, the indebtedness must accrue to the shareholder to qualify under IRC Section 1374(c)(2)(B) and a trust while a separate juridical entity like a partnership is also a taxpayer. As a result, the Tax Court held that an obligation to an estate of which the shareholder was executrix and sole beneficiary is not an indebtedness of the S corporation to the shareholder. Therefore, the Court did not allow the S corporation losses deducted by the shareholder.

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

The adjustments described in IRC Section 1367(a) to the basis of a shareholder's stock are determined as of the close of the corporation's taxable year, and the adjustments generally are effective as of that date. However, 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. An adjustment for a nontaxable item is determined for the taxable year in which the item would have been includible or deductible under the corporation's method of accounting for federal income tax purposes if the item had been subject to federal income taxation. (Treas. Reg. Section 1.1367-1(d))

The amounts of the adjustments to basis of indebtedness (including open account debt) provided in IRC Section 1367(b)(2) are determined as of the close of the S corporation's taxable year, and the adjustments are generally effective as of the close of the S corporation's taxable year. However, if the shareholder is not a shareholder in the S corporation at that time, the adjustments are effective immediately before the shareholder terminates his/her interest in the S corporation. (Treas. Reg. Section 1.1367-2(d))

If a debt is disposed of or repaid in whole or in part before the close of the taxable year, the basis of that indebtedness is restored under Treas. Reg. Section 1.1367-2(c) effective immediately before the disposition or the first repayment on the debt during the taxable year. To the extent any indebtedness of the S corporation to the shareholder is disposed of or repaid (in whole or in part) during the taxable year and the shareholder's basis in that indebtedness has been reduced under Treas. Reg. Section 1.1367-2(b) and is not restored completely under Treas. Reg. Section 1.1367-2(c), the disposition or repayment is a recognition event effective immediately before the indebtedness is disposed of or repaid (in whole or in part). (Treas. Reg. Section 1.1367-2(d))

9.6.2 Ordering Rules for Adjustments to Stock and Debt Basis

a. Ordering rules Pre-1997

Treas. Reg. Section 1.1367-1(e) provides the following ordering rules for the adjustments to the shareholder's basis for taxable years beginning before January 1, 1997:

(1) Any increase in basis attributable to the **income** items described in IRC Section 1367(a)(1)(A) and (B) and the excess of the deductions for depletion described in IRC Section 1367(a)(1)(C);

(2) Any decrease in basis, but not below zero, attributable to noncapital, nondeductible **expenses** described in IRC Section 1367(a)(2)(D) and the oil and gas depletion deduction described in IRC Section 1367(a)(2)(E);

(3) Any decrease in basis, but not below zero, attributable to items of **loss** or **deduction** described in IRC Section 1367(a)(2)(B) and (C); and

(4) Any decrease in basis, but not below zero, attributable to a **distribution** by the corporation described in IRC Section 1367(a)(2)(A).

b. Ordering rules Post-1997

Treas. Reg. Section 1.1367-1(f) provides the following ordering rules for the adjustments to the shareholder's basis for taxable years beginning on or after August 18, 1998:

(1) Any increase in basis attributable to the **income** items described in IRC Section 1367(a)(1)(A) and (B), and the excess of the deductions for depletion described in IRC Section 1367(a)(1)(C);

(2) Any decrease in basis, but not below zero, attributable to a **distribution** by the corporation described in IRC Section 1367(a)(2)(A);

(3) Any decrease in basis, but not below zero, attributable to noncapital, nondeductible **expenses** described in IRC Section 1367(a)(2)(D), and the oil and gas depletion **deduction** described in IRC Section 1367(a)(2)(E); and

(4) Any decrease in basis, but not below zero, attributable to items of **loss** or **deduction** described in IRC Section 1367(a)(2)(B) and (C).

Note: For taxable years beginning on or after January 1, 1997 and before August 18, 1998, the basis of a shareholder's stock must be determined in a reasonable manner taking into account the statute and legislative history (Treas. Reg. Section 1.1367-3). In other words, the ordering rules for taxable years beginning on or after August 18, 1998, may be utilized on an elective basis during this transition period.

Under Treas. Reg. Section 1.1367-1(g) a shareholder may elect to decrease his basis for his share of separately computed items of loss, and nonseparately computed loss before reducing his basis for nondeductible, noncapital expenses, and the oil and gas depletion deduction. If the shareholder makes the election, to the extent the nondeductible, noncapital expenses, and the oil and gas depletion deduction exceeds the shareholder's basis, these items reduce basis in the following year. This election allows a shareholder to deduct additional losses before reducing his basis for nondeductible items.

The election is made by attaching a statement to the shareholder's timely filed original or amended return that states that the shareholder agrees to the carryover rule mentioned in the above paragraph. Once a shareholder makes the election for an S corporation, the shareholder must continue to apply the elective ordering rules mentioned in the above paragraph for all future years of the S corporation, unless the shareholder receives permission from the IRS to apply different rules.

c. Special Rules for Debt Basis

- Shareholder Advances/Line of Credit

  Treas. Reg. Section 1.1367-2(a)(2) provides that "open account debt" means shareholder advances **not evidenced by separate written instruments and repayments on the advances**, the aggregate outstanding principal of which does not exceed $25,000 of indebtedness of the S corporation to the shareholder at the close of the S corporation's taxable year. Advances and repayments on open account debt are **treated as a single indebtedness**.

- Multiple Indebtedness

  Treas. Reg. Section 1.1367-2(b)(3) provides that "[i]f a 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."

- Special Rules

  Reduction in Basis of Indebtedness

  If after making the adjustments required by IRC Section 1367(a)(1) for any taxable year of the S corporation, the amounts specified in IRC Section 1367(a)(2)(B), (C), (D), and (E) (relating to losses, deductions, noncapital, nondeductible expenses, and certain oil and gas depletion deductions) **exceed** the basis of a shareholder's stock in the corporation, the **excess** is applied to reduce **(but not below zero)** the basis of any indebtedness of the S corporation to the shareholder held by the shareholder at the close of the corporation's taxable year. Please note that the excess of distributions over stock basis **is not applied** to reduce the basis of any indebtedness of the S corporation to the shareholder. A distribution in excess of the stock basis will result in capital gain even if the shareholder has basis in the debt of the S corporation. (IRC Section 1368(b)(2))

  The following indebtedness items are not treated as held by the shareholder at the close of the year and are not subject to basis reduction: (Treas. Reg. Section 1.1367-2(b)(2))

  - Any indebtedness that was satisfied by the corporation during the tax year.
  - Any indebtedness that was disposed of by the shareholder during the tax year.
  - Any indebtedness that was forgiven by the shareholder during the tax year.

  The rules stated in Treas. Reg. Section 1367-2(b)(1) are also applied if a shareholder terminates his/her interest in the corporation during the taxable year **immediately prior to the termination** of the shareholder's interest in the corporation. (Treas. Reg. Section 1.1367-2(b)(2))

Restoration of Basis in Indebtedness

Starting after December 31, 1982, if for any taxable year of an S corporation, there has been a reduction in the basis of an indebtedness of the S corporation to a shareholder under IRC Section 1367(b)(2)(A), any net increase in any subsequent taxable year of the corporation is applied to restore that reduction. For purposes of IRC Section 1367, net increase with respect to a shareholder means the amount by which the shareholder's pro rata share of the income items described in IRC Section 1367(a)(1) **exceed** the items described in IRC Section 1367(a)(2) for the taxable year. These restoration rules apply only to indebtedness held by a shareholder as of the beginning of the taxable year in which the net increase arises. The reduction in basis of indebtedness must be restored before any net increase is applied to restore the basis of a shareholder's stock in an S corporation. In no event may the shareholder's basis of indebtedness be restored above the adjusted basis of the indebtedness under IRC Section 1016(a), excluding any adjustments under IRC Section 1016(a)(17) for prior taxable years, determined as of the beginning of the taxable year in which the net increase arises. (Treasury Regulations Section 1.1367-2(c)(1))

If a shareholder holds more than one indebtedness (including any open account debt and any debt treated as a single indebtedness) as of the beginning of an S 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 (including any open account debt and any debt treated as a single indebtedness) in proportion to the amount that the basis of each outstanding indebtedness has been reduced under IRC Section 1367(b)(2)(A) and Treasury Regulations Section 1.1367-2(b) and not restored under IRC Section 1367(b)(2)(B) and Treasury Regulations Section 1.1367-2(c)(2).

d. Allocation of Losses / Deductions

Where the shareholder's pro rata share of the S corporation's **separately** stated and **nonseparately** stated losses and deductions **exceeds** the shareholder's basis in the stock and debt of the corporation, the limitation on losses and deductions under IRC Section 1366(d)(1) is allocated among the shareholder's pro rata share of each loss or deduction. The amount of the limitation allocated to each loss or deduction is the amount that bears the same ratio of the amount of the limitation as the loss or deduction bears to the total of the losses and deductions. For allocation purposes, the total of losses and deductions for the tax year includes losses and deductions that were previously disallowed and carried forward from prior years. (Treas. Reg. Section 1.1366-2(a)(5))

IRC Section 1366 and related regulations do not provide guidance for allocating deductible loss and deduction items that exceed basis. Treas. Reg. Section 1.469-2T(d)(6)(ii)(B) provides guidance for the allocation of losses/deductions in excess of stock and debt basis as follows:

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 Section 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 deduction or loss is the amount 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 E

	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
	(30,000)	.20	-10,000	-20,000
Total	(150,000)	1.00	-50,000	-100,000
Ending Balance			$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 Section 1366(d)(2)). Suspended losses/deductions are carried over and combined with the next year’s losses/deductions. No distinctions are made in regard to when the actual losses/deductions were generated.

9.7 LOAN REPAYMENTS ON REDUCED DEBT BASIS

After the basis in indebtedness has been reduced by the S corporation's losses and deductions, subsequent repayment(s) of the amount of the debt will produce income to the shareholder. This income arises because the reduction to basis in indebtedness represents prior losses already deducted, which must be recaptured.

- The computation of the income/gain depends on whether the debt is evidenced by a formal note or an open account/line of credit.
- The character of the income/gain also depends on whether the debt is evidenced by a formal note or an open account/line of credit.

Formal Note – Capital gain treatment (Rev. Rul. 64-162)
Open Account or Line of Credit – Ordinary income treatment (Rev. Rul. 68-537)

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 formulas for determining the taxable income portion of the debt repayment and the return of basis.

$$\frac{[\text{Face Amount of Debt - Adjusted Debt Basis}]}{\text{Face Amount of Debt}} \times \text{Debt Repayment} = \textbf{Gain on Repayment}$$

Debt Repayment – Gain on Repayment = **Return of Basis**

Example F

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

Taxable Portion of Loan Repayment: $\frac{100{,}000 - 40{,}000}{100{,}000} \times 30{,}000 = \mathbf{\$18{,}000}$

Return of Debt Basis: 30,000 - 18,000 = **$12,000**

After taking into consideration the loan repayment, the 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.

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 ordinary income. (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. (*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. Section 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. Section 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.
- Then, any remaining increase in basis is applied to restore the basis in all of the other loans (Treas. Reg. Section 1.1367-2(c)(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 first be used to restore the basis of any loan repaid during the taxable year. 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 also applicable to the open account loan (line of credit) (Treas. Reg. Section 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 an open 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 single 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 held 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 G

LOAN REPAYMENT - CALCUATION OF TAXBLE PORTION

(Line of Credit Case)

	Sch K-1 Items	Stock Basis	Debt Basis	Total Debt (Face Amount)	Repayment	Taxable Repayment
Initial Investment		$11,000				
2014						
Loan - 07/15/14			$6,000	$6,000		
Losses	($13,500)	(11,000)	(2,500)			
Adj. Basis - 12/31/14		0	$3,500	$6,000		
2015						
Loan - 01/15/15			$4,000	$4,000		
Subtotal			$7,500	$10,000		
Repayment - 03/15/15			(1,500)	(2,000)	(2,000)	(500)
Loan - 06/15/15			2,500	2,500		
Subtotal			8,500	10,500		
Repayment - 08/15/15			(2,429)	(3,000)	(3,000)	(571)
Adj. Basis - 12/31/15			$6,071	$7,500		

Note 1: Debt basis can only be restored up to the face amount of the indebtedness. Net increases can only restore debt basis to the face amount of the indebtedness. (Treas. Reg. Section 1.1367-2(c)(1))

Note 2: Under the old method of "netting", it is interesting to note that for tax year 2015 the total loans of $6,500 exceed the repayments of $5,000 and there would have been no taxable gain.

03/15/15 Taxable Portion & Deemed Debt Repayment

- Taxable Portion of Debt Repayment: $\frac{10{,}000 - 7{,}500}{10{,}000}$ x 2,000 = $500
- Deemed Debt Repayment [Return of Debt Basis]: 2,000 - 500 = $1,500

08/15/15 Taxable Portion & Deemed Debt Repayment

- Taxable Portion of Loan Repayment: $\frac{10{,}500 - 8{,}500}{10{,}500}$ x 3,000 = $571
- Deemed Debt Repayment [Return of Debt Basis]: 3,000 - 571 = $2,429

Example G assumes that there is no income or loss for tax year 2015. The next example will show how the calculation will be done when there is a loss (net decrease) for tax year 2015.

Example H

LOAN REPAYMENT - CALCUATION OF TAXBLE PORTION
(Line of Credit Case)

	Sch K-1 Items	Stock Basis	Debt Basis	Total Debt (Face Amount)	Repayment	Taxable Repayment
Initial Investment		$11,000				
2014						
Loan - 07/15/14			$6,000	$6,000		
Losses	($13,500)	(11,000)	(2,500)			
Adj. Basis - 12/31/14		0	$3,500	$6,000		
2015						
Loan - 01/15/15			$4,000	$4,000		
Subtotal			$7,500	$10,000		
Repayment - 03/15/15			(1,500)	(2,000)	(2,000)	(500)

Loan - 06/15/15			2,500	2,500		
Subtotal			8,500	10,500		
Repayment - 08/15/15			(2,429)	(3,000)	(3,000)	(571)
Losses	(1,500)		(1,500)			
Adj. Basis - 12/31/15			$4,571	$7,500		

Note: Under the old method of "netting," it is interesting to note that for tax year 2015 the total loans of $6,500 exceed the repayments of $5,000 and there would have been no taxable gain.

Everything is the same, even the taxable portion of the repayments. However, 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 income (net increase) for tax year 2015.

Example I

LOAN REPAYMENT - CALCUATION OF TAXABLE PORTION
(Line of Credit Case)

	Sch K-1 Items	Stock Basis	Debt Basis	Total Debt (Face Amount)	Repayment	Taxable Repayment
Initial Investment		$11,000				
2014						
Loan - 07/15/14			$6,000	$6,000		
Losses	($13,500)	(11,000)	(2,500)			
Adj. Basis - 12/31/14		0	$3,500	$6,000		
2015						
Income	1,500		$1,500			
Loan - 01/15/15			$4,000	$4,000		
Subtotal			$9,000	$10,000		
Repayment - 03/15/15			(1,800)	(2,000)	(2,000)	(200)
Loan - 06/15/15			2,500	2,500		
Subtotal			9,700	10,500		

Repayment - 08/15/15	(2,771)	(3,000)	(3,000)	(229)
Adj. Basis - 12/31/15	$6,929	$7,500		

Note 1: Net increases can only restore debt basis to the face amount of the indebtedness. [Treasury Regulations Section 1.1367-2(c)(1)]

Note 2: Under the old method of "netting," it is interesting to note that for tax year 2015 the total loans of $6,500 exceed the repayments of $5,000 and there would have been no taxable gain.

03/15/15 Taxable Portion & Deemed Debt Repayment

- Taxable Portion of Debt Repayment: $\frac{10{,}000 - 9{,}000}{10{,}000} \times 2{,}000 = \$200$
- Deemed Debt Repayment [Return of Debt Basis]: 2,000 - 200 = $1,800

08/15/15 Taxable Portion & Deemed Debt Repayment

- Taxable Portion of Loan Repayment: $\frac{10{,}500 - 9{,}700}{10{,}500} \times 3{,}000 = \$229$
- Deemed Debt Repayment [Return of Debt Basis]: 3,000 - 229 = $2,771

You can see the taxable amounts in Example I are less than the previous two examples because the S corporation has income (net increase) in tax year 2015 and can restore debt basis before the computation of the taxable repayments.

In summary, Treas. Reg. Section 1.1367-2 and the Tax Court's decision in *Novell, supra,* require 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.
- 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).

9.7.4 Debt Repayments on Open Account Debt (aggregate amount not exceeding $25,000)

Open account debt is defined as shareholder advances to the S corporation not evidenced by separate written instruments, where the aggregate amount of the advances and repayments is not more than $25,000 at the close of the S corporation's taxable year. This $25,000 threshold amount is separately applied to each shareholder. Advances and repayments on open account debt are treated as a single indebtedness. (Treas. Reg. Section 1.1367-2(a)(2)(i))

If an open account debt exceeds the $25,000 threshold amount at the close of the S corporation's taxable year, the aggregate amount of the advances and repayments are treated as open account debt for that tax year and as debts evidenced by a separate written instrument for any subsequent tax year. In any subsequent tax year, the netting of advances with repayment is not allowed and the rules regarding restoration of basis for multiple loans are applied. (Treas. Reg. Section 1.1367-2(a)(2)(ii))

9.8 APPLICATION OF THE BASIS RULES - PROBLEMS

Following is a series of problems located at the end of this section 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 Dispositions Qualifying for the Election to Divide the Taxable Year

Treas. Reg. Section 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 that each shareholder who held stock in the corporation during the taxable year consents to this election. For elections made for taxable years before January 1, 2003, the election statement must be signed by an officer of the corporation. For taxable years, after December 31, 2002, the election statement is verified by signing the return.

Note: An election made under this regulation is irrevocable. The election to divide the taxable year may be made when a disposition of an entire ownership interest occurs during the taxable year (IRC Section 1377(a)(2)), or when a qualifying disposition occurs for taxable years beginning on or after January 1, 1994 (Treas. Reg. Section 1.1368-1(g)(2)(ii)). A qualifying disposition is one of the following:

- A disposition by a shareholder of 20 percent 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 Section 302(a) or IRC Section 303(a) of 20percent 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.
- An issuance of an amount of stock equal to or greater than 25 percent 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 as a result of 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 Section 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.

9.9.2 Making the Election

The election to divide the taxable year can be made when a disposition of an entire ownership interest occurs during the taxable year (IRC Section 1377(a)(2)), or when a qualifying disposition occurs for taxable years beginning on or after January 1, 1994 (Treas. Reg. Section 1.1368-1(g)(2)(ii)). A qualifying disposition is one of the following:

- A disposition by a shareholder of 20 percent 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 Section 302(a) or IRC Section 303(a) of 20 percent 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.
- An issuance of an amount of stock equal to or greater than 25 percent 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 upon the death of a shareholder. In that event, 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 Section 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.

9.9.3 Effective Date

An election for qualifying dispositions is effective for taxable years beginning on or after January 1, 1994. For taxable years prior to January 1, 1994, only entire stock dispositions were allowed to make this election.

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-1s 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 accumulated 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 J

Joe owns 80 percent of the stock in Alpha Corporation, an S corporation. For tax year 12/2015, Joe had a beginning stock basis of $0, debt basis of $0, and actual debt of $100,000. In addition, Joe had a previously suspended flow-through capital loss of ($50,000) and rental loss of ($20,000). Per Joe's Schedule K-1 from Alpha Corporation, he had flow-through ordinary income of $300,000, a capital loss of ($70,000) and a rental loss of ($15,000) for tax year 12/2015. At the end of tax year 12/2015, Joe sold his stock in Alpha for $300,000. Joe would compute his gain(loss) for the sale of his stock in Alpha Corporation as follows:

Description	Prior Year Losses	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	200,000	100,000	
Capital Loss	($50,000)	(70,000)	(120,000)	(120,000)		
Rental Loss	(20,000)	(15,000)	(35,000)	(35,000)		
Net Increase			$145,000		$100,000	$100,000
Ending Balance				45,000		
Proceeds from Stock Sale				300,000		
Gain(Loss) on Stock Sale				$255,000		

Disregarding other applicable limitations, the shareholder would report the following amounts on his tax return:

- Ordinary Income $300,000 Schedule E
- Capital Loss ($120,000) Schedule D
- Rental Loss ($35,000) Schedule E
- Capital Gain $255,000 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 Section 1366(d)(2)). As a result, no part of the excess of the loss/deduction can be carried over and used by the new shareholder. Gain on the stock disposition does not increase the disposing shareholder's basis.

Example K

Jan owns 80 percent of the stock in Gamma Corporation, an S corporation. For tax year 12/2015, Jan had zero stock basis. In addition, Jan had previously suspended flow through ordinary loss of ($50,000) and rental loss of ($20,000). Per Jan's Schedule K-1 from Gamma Corporation, she had flow through interest income of $10,000, ordinary loss of ($70,000) and rental loss of ($15,000) for tax year 12/2015. At the end of tax year 12/2015, Jan sold her stock in Gamma Corporation for $300,000. Jan would compute her stock basis, currently suspended losses, and the gain(loss) for the sale of her stock in Gamma Corporation as follows:

Description	Prior Year Suspended Losses	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)		($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 on her tax return:

- Interest Income $10,000 Schedule B
- Ordinary Loss ($7,742) Schedule E
- Rental Loss ($2,258) Schedule E
- Capital Gain $300,000 Schedule D [Stock Sale]

The following suspended losses "belong" to the shareholder and will be lost. These suspended losses 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 suspended losses.

a. Treatment of Suspended Losses Incident to Divorce

IRC Section 1366(d)(2) provides that any loss disallowed by the basis limitation in IRC Section 1366(d)(1) is treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder. The use of the words "with respect to that shareholder" in IRC Section 1366(d)(2) requires that all losses be personal to a shareholder and that the losses not be transferred in any manner.

With the enactment of 2004 Jobs Act, IRC Section 1366(d)(2)(B) was added and provided that where there is an IRC Section 1041(a) transfer of S corporation stock to a spouse (or former spouse incident to divorce), any losses disallowed or suspended are carried over to the spouse or former spouse. Treas. Reg. Section 1.1366-2(a)(6)(ii) further explains that these suspended or disallowed losses shall be treated as incurred by the corporation in the following taxable year with respect to the transferee spouse or former spouse. The amount of the disallowed or suspended losses is prorated for the year of transfer between the transferor and transferee or former spouse based on the stock ownership at the beginning of the following tax year. In other words, the transferor would be first to carryover the losses in the year of transfer, but if the transferor does not use all of the losses in the year of transfer, the remaining loss will be prorated based on stock ownership beginning in the following year.

b. Treatment of Suspended Losses Upon Death of Spouse

As with divorce, the treatment of the transfer of a decedent's suspended losses to the surviving spouse is governed by IRC Section 1366(d)(2)(B), any disallowed or suspended losses are carried over 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 Section 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 Section 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, as defined in Section 1371 of the Internal Revenue Code of 1954, 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 corporation's 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 shareholder's 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 in part to the return of the shareholder's basis in the loan and in 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 L

Bob is a shareholder in ABC Corporation. On January 15, 2015, Bob sold his stock in ABC Corporation. Bob had a debt basis of $20,000 and actual debt of $180,000 at the date of his stock disposition. Three months after the stock disposition, Bob received a loan repayment of $100,000 from ABC Corporation. Bob would compute his gain on the loan repayment and return of debt basis as follows:

	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: $\frac{180{,}000 - 20{,}000}{180{,}000} \times 100{,}000 = \$88{,}889$

Deemed Debt Repayment [Return of Debt Basis]: 100,000 - 88,889 = $11,111

The shareholder would report a capital or ordinary gain of $88,889 for the taxable portion of the loan repayment.

If the note becomes 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 S Corporation Manual Section 15.0 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 during the last taxable

year of a corporation for which it is an S corporation (IRC Section 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 term post termination transition period means the following:

- 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 Section 1377(b)(1)(A))

- 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 Section 1368(e)(2)). (IRC Section 1377(b)(1)(B))

- The 120-day period beginning on the date of a determination that the corporation's election under IRC Section 1362(a) had terminated for a previous taxable year. (IRC Section 1377(b)(1)(C))

Example M

Last S Corporation Year

Description	Schedule K-1 Items	Stock Basis	Debt Basis	Suspended Items
Beginning Balance		$10,000	$100,000	$0
Ordinary Income	$5,000	5,000		
Subtotal		15,000	100,000	0
IRC Section 1231 Loss	(250,000)	(15,000)	(100,000)	(135,000)
Ending Balance		$0	$0	($135,000)

Post Termination Transition Period

Description	Schedule K-1 Items	Stock Basis	Debt Basis	Suspended Items
Beginning Balance		$0	$0	($135,000)
Capital Contributions		120,000		
Suspended Losses		(120,000)		120,000
Ending Balance		$0	$0	($15,000)

Disregarding other applicable limitations, the shareholder would report the following amounts on his/her tax return:

Last S Corporation Year:

• Ordinary Income	$5,000	Schedule E
• IRC Section 1231 Loss	($115,000)	Form 4797

Post Termination Transition Period:

• IRC Section 1231 Loss	($120,000)	Form 4797

The shareholder would lose the following suspended loss:

• IRC Section 1231 Loss	($15,000)

The shareholder's basis in stock, for purposes of determining the gain or loss on the stock disposition, is zero. Future loan repayments would be taxable 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 IRC Section 1231 Loss of $15,000.

9.13 INTERACTION BETWEEN SUSPENDED LOSSES AND NET OPERATING LOSS CARRYOVERS

Because California allowed only a percentage (50-60 percent) of net operating losses to be carried over for tax years beginning before January 1, 2004, (R&TC Section 24416(b)(1)) it was more beneficial for a shareholder to suspend losses/deductions due to insufficient basis when they had a taxable loss for those years. However, for tax years beginning after January 1, 2004, California allows 100 percent of net operating losses to be carried over. Therefore, for tax years beginning on or after January 1, 2004, there is no difference to a shareholder in terms of tax benefit between suspending losses/deductions due to insufficient basis or reporting losses/deductions with sufficient basis which are limited due to net operating loss limitations.

In addition, for tax years beginning on or after January 1, 2013, California allows between 50-100 percent of net operating losses to be carried back to the two taxable years preceding the tax year of the loss.

9.14 ALTERNATIVE MINIMUM TAX & SUSPENDED LOSSES

The S corporation is not subject to the alternative minimum tax (AMT); however, there may be an AMT adjustment and preference items generated by the S corporation that affect the shareholder’s AMT computation. These AMT items will be shown on the Schedule K-1.

For purposes of determining the AMT adjustment, the shareholder's basis must be computed separately for regular tax and for AMT. IRC Section 59(h) states that limitation of IRC Section 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 Section 56, IRC Section 57, and IRC Section 58.

Example N

In Year 1, the shareholder of an S Corporation had beginning stock basis of $10,000 for regular tax and $10,000 for AMT. In addition, the shareholder had no suspended losses for both regular tax and AMT. For Year 1 and Year 2, the shareholder had the following flow-through items of income, loss, deductions, and AMT adjustment and preference items:

	Year 1	**Year 2**
Ordinary Loss	($100,000)	($25,000)
Interest Income	20,000	-
Capital Gain	-	50,000
AMT Depreciation	90,000	(25,000)
AMT Basis Adjustment	-	(10,000)

Description	**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
Items:					
Interest Income	$20,000	20,000		20,000	
Ordinary Loss	(100,000)	(30,000)	(70,000)	(100,000)	
AMT Depreciation	90,000			90,000	
Net Increase (Decrease)		(10,000)	(70,000)	$10,000	
Ending Balance		$0	($70,000)	$20,000	$0

Description	**Schedule K-1 Items**	**Stock Basis Regular Tax**	**Suspended Losses Regular Tax**	**Stock Basis AMT**	**Suspended Losses AMT**
		Year 2			
Beginning Balance		$0	($70,000)	$20,000	$0
Items:					
Capital Gain	$500,000	500,000		500,000	
Ordinary Loss	(25,000)	(25,000)		(25,000)	
AMT Basis Adjustment	(10,000)			(10,000)	
AMT Depreciation	(25,000)			(25,000)	
Suspended Loss	(70,000)	(70,000)	70,000		
Net Increase		405,000		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 of, the AMT basis adjustment will be the difference between ending regular tax and AMT stock basis.

9.15 INFORMATION DOCUMENT REQUESTS

The 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 (Computation of shareholder basis by the auditor should be computed from first year of California S corporation, last confirmed shareholder basis computation (if a prior audit was conducted) or from the first tax year in which information is available.)
- Copies of shareholder returns and California Schedule K-1s. (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 loan agreements / promissory 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.

The following are suggestions for information and documents to be requested from the S corporation:

- Request corporate journal entries to verify how the corporation booked the loan(s).
- Copies of journal entries computing interest payments on the notes and actual interest payments made.
- Copies of journal entries for any actual repayment(s) on the note.
- Copies of trial balance work papers for the years you are computing shareholder basis for. This includes the trial balance work papers 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 examination of each shareholder must be conducted independently of the S corporation examination.

If other issues are selected for examination, complete these issues before proceeding with the shareholder 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 O

The auditor obtains (1) ABC, Inc.'s 2012 – 2014 corporate tax returns and (2) the 2012-2014 individual tax returns of ABC's sole shareholder, John. The auditor sends a contact letter to John on December 1, 2015. The auditor determines that John recognized $1,000,000 of losses in excess of basis for tax year 2014. Prior to completion of the audit, John files his 2015 individual return reporting a pass-through capital gain from ABC, Inc. totaling $25,000,000.

Since John had sufficient basis in 2015 to take the $1,000,000 suspended loss from 2014, the tax potential on the 2014 adjustment will be impacted due to the timing adjustment.

The following factors should be determined before proceeding with the shareholder basis issue:

- Whether the shareholder recognized losses against debt basis during any of the open statute years.
- Whether the shareholder reported taxable loan repayments during any of the open statute years.
- Whether the overall tax effect after taking into consideration losses suspended at the shareholder basis level (100 percent carryover) versus losses recognized at the shareholder basis level but carried over as a net operating loss during the years in which there is a limitation on the net operating loss.

PROBLEM 1

General Rule Stock Basis

The shareholder of an S corporation has beginning stock basis of $10,000 for the tax year. Per the shareholder's Schedule K-1 from the S corporation, the shareholder had flow-through ordinary income of $100,000 and charitable contributions of $10,000 for the tax year. The shareholder would compute his/her stock basis in the S corporation as follows:

Description	Schedule K-1 Items	Stock Basis	
Beginning Balance		$10,000	
Ordinary Income	$100,000	100,000	1
Subtotal		110,000	
Charitable Contributions	(10,000)	(10,000)	2
Ending Balance		$100,000	

Disregarding other applicable limitations, the shareholder would report the following amounts on his/her tax return:

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

In this example, the shareholder would follow the ordering rules of IRC Section 1367(a):

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

The shareholder of an S corporation has beginning stock basis of $10,000 and zero previously suspended loss for the tax year. Per the shareholder's Schedule K-1 from the S corporation, the shareholder has flow-through ordinary income of $10,000 and a capital loss of ($100,000) for the tax year. The shareholder would compute his/her stock basis and suspended loss in the S corporation as follows:

Description	Schedule K-1 Items	Stock Basis		Suspended Loss
Beginning Balance		$10,000		$0
Ordinary Income	$10,000	10,000	1	
Subtotal		20,000		
Capital Loss	(100,000)	(20,000)	2	(80,000)
Ending Balance		$0		(80,000)

Disregarding other applicable limitations, the shareholder would report the following amounts on his/her tax return:

- Ordinary Income $10,000 Schedule E
- Capital Loss ($20,000) Schedule D

The shareholder would currently suspend the following loss/deduction:

- Capital Loss ($80,000) [100,000 - 20,000]

In this example the shareholder would follow the ordering rules of IRC Section 1367(a):

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 loss/deduction items in excess of stock basis as provided under IRC Section 1367(b)(2)(A). As a result, ($80,000) of the capital loss is disallowed and suspended to the succeeding tax year.

PROBLEM 3

General and Special Rule Stock and Debt Basis Reduced to Zero

The shareholder of an S corporation has beginning stock basis of $10,000 and beginning debt basis of $100,000 for the tax year. Per the shareholder's Schedule K-1 from the S corporation, the shareholder has flow-through ordinary income of $40,000 and a capital loss ($150,000) for the tax year. The shareholder would compute his/her stock and debt basis in the S corporation as follows:

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

Disregarding other applicable limitations, the shareholder would report the following amounts on his/her tax return:

- Ordinary Income $40,000 Schedule E
- Capital Loss ($150,000) Schedule D

In this example the shareholder would follow the ordering rules of IRC Section 1367(a) and IRC Section 1367(b)(2)(A):

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, by loss/deduction items in excess of stock basis.

PROBLEM 4

General Rule Distribution in Excess of Stock basis with Existing Debt Basis

The shareholder of an S corporation has beginning stock basis of $10,000 and beginning debt basis of $10,000 for the tax year. Per the shareholder's Schedule K-1 from the S corporation, the shareholder has flow-through ordinary income of $10,000 and distributions of $100,000 for the tax year. The shareholder would compute his/her stock and debt basis in the S corporation as follows:

Description	Schedule K-1 Items	Stock Basis		Debt Basis
Beginning Balance		$10,000		$10,000
Ordinary Income	$10,000	10,000	1	
Subtotal		20,000		10,000
Distribution	(100,000)	(20,000)	2	
Ending Balance		$0		$10,000

Disregarding other applicable limitations, the shareholder would report the following amounts on his/her tax return:

- Ordinary Income $10,000 Schedule E
- Capital Gain $80,000 Schedule D - Taxable Distributions [100,000 - 20,000]

In this example the shareholder would follow the ordering rules of IRC Section 1367(a):

1. Increase stock basis by income items.
2. Decrease stock basis, but not below zero, by distributions.

PROBLEM 5

Special Rule Debt Restoration

The shareholder of an S corporation has zero beginning stock basis, zero beginning debt basis, and beginning actual debt of $10,000 for the tax year. Per the shareholder's Schedule K-1 from the S corporation, the shareholder has flow-through ordinary income of $100,000 and charitable contributions of $5,000 for the tax year. The shareholder would compute his/her stock and debt basis in the S corporation as follows:

Description	Schedule K-1 Items - Net Increase (Decrease)	Stock Basis	Debt Basis	Actual Debt
Beginning Balance		$0	$0	$10,000
Ordinary Income	$100,000	90,000 [2]	10,000 [1]	
Charitable Contributions	(5,000)	(5,000) [3]		
Net Increase	95,000			
Debt Restoration	(10,000)			
Remainder Net Increase	85,000			
Ending Balance		$85,000	$10,000	$10,000

Disregarding other applicable limitations, the shareholder would report the following amounts on his/her tax return:

- Ordinary Income $100,000 Schedule E
- Charitable Contributions ($5,000) Schedule A

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

In this example the shareholder would follow the ordering rules of IRC Section 1367(b)(2)(B) and IRC Section 1367(a):

1. Restore debt basis first (up to the amount of the actual debt) by the amount of the net increase for year.
2. Increase stock basis by income items.
3. Decrease stock basis, but not below zero, by loss/deduction items.

Under IRC Section 1367(b)(2)(B), the shareholder would restore debt basis first 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.

PROBLEM 6

General Rule - Unrestored Debt and Net Decrease

The shareholder of an S corporation has zero beginning stock basis, zero beginning debt basis, and beginning actual debt of $10,000 for the tax year. Per the shareholder's Schedule K-1 from the S corporation, the shareholder has flow through ordinary income of $10,000 and charitable contributions of $110,000 for the tax year. The shareholder would compute his/her stock basis, debt basis, and suspended loss/deductions in the S corporation as follows:

Description	Schedule K-1 Items	Stock Basis		Debt Basis	Actual Debt	Suspended Loss / Deductions
Beginning Balance		$0		$0	$10,000	$0
Ordinary Income	$10,000	10,000	1			
Charitable Contributions	(110,000)	(10,000)	2			(100,000)
Net Decrease	(100,000)					
Ending Balance		$0		$0	$10,000	($100,000)

Disregarding other applicable limitations, the shareholder would report the following amounts on his/her tax return:

- Ordinary Income $10,000 Schedule E
- Charitable Contributions ($10,000) Schedule A

The shareholder would currently suspend the following loss/deduction item.

- Charitable Contributions ($100,000)

In this example, the shareholder would follow the ordering rules of IRC Section 1367(a):

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

Under IRC Section 1367(b)(2)(B), the shareholder is required to restore debt basis first only if there is a net increase for the year. In this problem, the shareholder had a net decrease of $100,000; therefore, the shareholder would follow the ordering rules of IRC Section 1367(a).

PROBLEM 7a

Ordering Rules - Pre-1997

The shareholder of an S corporation has $10,000 beginning stock basis for tax year 12/1995. Per the shareholder's Schedule K-1 from the S corporation, the shareholder has flow-through interest income of $50,000, ordinary loss of ($10,000), capital loss of ($10,000), 50 percent meals & entertainment expense deduction of $5,000, oil & gas depletion of $5,000, charitable contributions of $10,000, and distributions of $20,000 for tax year 12/1995. The shareholder would compute his/her stock basis in the S corporation using the ordering rules for tax years beginning before January 1, 1997 as follows:

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

Disregarding other applicable limitations, the shareholder would report the following amounts on his/her tax return:

- Interest Income $50,000 Schedule B
- Oil & Gas Depletion ($5,000) Schedule E
- Ordinary Loss ($10,000) Schedule E
- Capital Loss ($10,000) Schedule D
- Charitable Contributions ($10,000) Schedule A
- The distribution is a nontaxable return of capital.

In this example, the shareholder would follow the ordering rules of Treas. Reg. Section 1.1367-1(e):

1. Increase stock basis by income items.
2. Decrease stock basis, but not below zero, by nondeductible expenses and oil & gas depletion items.
3. Decrease stock basis, but not below zero, by loss/deduction items.
4. Decrease stock basis, but not below zero, by distributions.

PROBLEM 7b

Ordering Rules - Post-1996

The shareholder of an S corporation has $10,000 beginning stock basis and zero previously suspended losses for tax year 12/2015. Per the shareholder's Schedule K-1 from the S corporation, the shareholder has flow-through interest income of $50,000, ordinary loss of ($10,000), capital loss of ($10,000), 50 percent meals & entertainment expense deduction of $5,000, oil & gas depletion of $5,000, charitable contributions of $10,000, and distributions of $20,000 for tax year 12/2015. The shareholder would compute his/her stock basis in the S corporation using the ordering rules for tax years after August 18, 1998 as follows:

Description	Schedule K-1 Items	Stock Basis	
Beginning Balance		$10,000	
Interest Income	$50,000	50,000	1
Subtotal		$60,000	
Distribution	(20,000)	(20,000)	2
Subtotal		$40,000	
50% Meals & Entertainment	(5,000)	(5,000)	3
Oil & Gas Depletion	(5,000)	(5,000)	3
Subtotal		$30,000	
Ordinary Loss	(10,000)	(10,000)	4
Capital Loss	(10,000)	(10,000)	4
Charitable Contributions	(10,000)	(10,000)	4
Ending Balance		$0	

Disregarding other applicable limitations, the shareholder would report the following amounts on his/her tax return:

- Interest Income $50,000 Schedule B
- Oil & Gas Depletion ($5,000) Schedule E
- Ordinary Loss ($10,000) Schedule E
- Capital Loss ($10,000) Schedule D
- Charitable Contributions ($10,000) Schedule A
- The distributions is a nontaxable return of capital.

In this example, the shareholder would follow the ordering rules of Treas. Reg. Section 1.1367-1(f):

1. Increase stock basis by income items.
2. Decrease stock basis, but not below zero, by distributions.
3. Decrease stock basis, but not below zero, by nondeductible expenses and oil & gas depletion items.
4. Decrease stock basis, but not below zero, by loss/deduction items.

PROBLEM 7c

Ordering Rules - Post-1996

The shareholder of an S corporation has zero stock basis and zero previously suspended losses for tax year 12/2015. Per the shareholder's Schedule K-1 from the S corporation, the shareholder has flow through ordinary income of $180,000, IRC Section 1231 loss of ($100,000), capital gain of $200,000, and distributions of $380,000 for tax year 12/2015. The shareholder would compute his/her stock basis in the S corporation and suspended loss/deductions using the ordering rules for tax years after August 18, 1998 as follows:

Description	Schedule K-1 Items	Stock Basis		Suspended Loss / Deduction
Beginning Balance		$0		$0
Ordinary Income	$180,000	180,000	1	
Capital Gain	200,000	200,000	1	
Subtotal		$380,000		$0
Distributions	(380,000)	(380,000)	2	
Subtotal		$0		
IRC Section 1231 Loss	(100,000)			(100,000)
Ending Balance		$0		($100,000)

Disregarding other applicable limitations, the shareholder would report the following amounts on his/her tax return:

- Ordinary Income $180,000 Schedule E
- Capital Gain $200,000 Schedule D
- The distributions is a nontaxable return of capital.

The shareholder would currently suspend the following loss/deduction item.

- IRC Section 1231 Loss ($100,000)

In this example the shareholder would follow the ordering rules of Treas. Reg. Section 1.1367-1(f):

1. Increase stock basis by income items.
2. Decrease stock basis, but not below zero, by distributions.

The shareholder has no debt basis in which to recognize loss/deduction items in excess of stock basis as provided under Treas. Reg. Section 1.1367-2(b)(1). As a result, ($100,000) of the IRC Section 1231 loss is disallowed and suspended to the succeeding tax year.

PROBLEM 8a

Ordering Rules/Proration of Suspended Losses - Pre-1997

The shareholder of an S corporation has $10,000 beginning stock basis, $10,000 beginning debt basis, and $10,000 actual debt for tax year 12/1995. Per the shareholder's Schedule K-1 from the S corporation, the shareholder has flow through interest income of $10,000, ordinary loss of ($50,000), capital loss of ($100,000), charitable contributions of $10,000, distributions of $10,000, 50% meals & entertainment expense deduction of $10,000, and oil & gas depletion of $40,000 for tax year 12/1995. The shareholder would compute his/her stock and debt basis in the S corporation and suspended loss/deductions using the ordering rules for tax years beginning before January 1, 1997 as follows:

Description	Schedule K-1 Items	Stock Basis	Debt Basis	Actual Debt	Suspended Loss
Beginning Balance		$10,000	$10,000	$10,000	$0
Interest Income	$10,000	10,000 [1]			
Subtotal		$20,000	$10,000	$10,000	$0
50% Meals & Entertainment	(10,000)	(4,000) [2]	(2,000) [3]		0
Oil & Gas Depletion	(40,000)	(16,000) [2]	(8,000) [3]		0
Subtotal		$0	$0	$10,000	$0
Ordinary Loss	(50,000)				(50,000)
Capital Loss	(100,000)				(100,000)
Charitable Contributions	(10,000)				(10,000)
Subtotal		$0	$0	$0	($160,000)
Distributions	(10,000)				
Ending Balance		$0	$0	$0	($160,000)

Proration of Currently Suspended Losses

Description	Total Loss	Loss Ratio	Allowed Loss Stock Basis	Allowed Loss Debt Basis	Suspended Loss
50% Meals & Entertainment	($10,000)	20.00%	($4,000)	($2,000)	$0
Oil & Gas Depletion	(40,000)	80.00%	(16,000)	(8,000)	(16,000)
Subtotal		100.00%	(20,000)	(10,000)	(16,000)
Ordinary Loss	(50,000)	31.25%			(50,000)
Capital Loss	(100,000)	62.50%			(100,000)
Charitable Contributions	(10,000)	6.25%			(10,000)
Total		100.00%			($176,000)

Disregarding other applicable limitations, the shareholder would report the following amounts on his/her tax return:

- Interest Income $10,000 Schedule B
- Oil & Gas Depletion $24,000 Schedule E
- Distributions $10,000 Schedule D

The $6,000 of 50 percent meals & entertainment deduction is only used to determine stock and debt basis and is not reported on the shareholder's tax return.

The shareholder would currently suspend the following loss/deduction items:

- Oil & Gas Depletion ($16,000)
- Ordinary Loss ($50,000)
- Capital Loss ($100,000)
- Charitable Contributions ($10,000)

In this example, the shareholder would follow the ordering rules of Treas. Reg. Section 1.1367-1(e) and Treas. Reg. Section 1.1367-2(b):

1. Increase stock basis by income items.
2. Decrease stock basis, but not below zero, by nondeductible expenses and oil & gas depletion items.
3. Decrease debt basis, but not below zero, by nondeductible expenses and oil & gas depletion items.

Under IRC Section 1366(d)(2)(A), the shareholder would disallow and suspend to the succeeding tax year the loss/deduction items (which affect the tax liability of the shareholder) in excess of his/her stock and debt basis for the tax year. Since the 50 percent meals & entertainment deduction do not affect the tax liability of the shareholder, the remaining balance of $4,000 [10,000 - 6,000] is only disallowed and will not be suspended to the succeeding tax year.

PROBLEM 8b

Ordering Rules/Proration of Suspended Losses - Post-1996

The shareholder of an S corporation has $10,000 of beginning stock basis, $10,000 of beginning debt basis, and $10,000 of actual debt for tax year 12/2015. Per the shareholder's Schedule K-1 from the S corporation, the shareholder has flow-through interest income of $10,000, ordinary loss of ($50,000), capital loss of ($100,000), charitable contributions of $10,000, distributions of $10,000, 50 percent meals & entertainment expense deduction of $10,000, and oil & gas depletion of $40,000 for tax year 12/2015. The shareholder would compute his/her stock and debt basis in the S corporation and suspended loss/deductions using the ordering rules for tax years after August 18, 1998 as follows:

Description	Schedule K-1 Items	Stock Basis	Debt Basis	Actual Debt	Suspended Loss
Beginning Balance		$10,000	$10,000	$10,000	$0
Interest Income	$10,000	10,000 [1]			
Subtotal		$20,000	$10,000	$10,000	$0
Distributions	(10,000)	(10,000) [2]			
Subtotal		$10,000	$10,000	$10,000	$0
50% Meals & Entertainment	(10,000)	(2,000) [3]	(2,000) [4]		0
Oil & Gas Depletion	(40,000)	(8,000) [3]	(8,000) [4]		(24,000)
Subtotal		$0	$0	$10,000	($24,000)
Ordinary Loss	(50,000)				(50,000)
Capital Loss	(100,000)				(100,000)
Charitable Contributions	(10,000)				(10,000)
Ending Balance		$0	$0	$0	($160,000)

Proration of Currently Suspended Losses

Description	Total Loss	Loss Ratio	Allowed Loss Stock Basis	Allowed Loss Debt Basis	Suspended Loss
50% Meals & Entertainment	($10,000)	20.00%	($2,000)	($2,000)	$0
Oil & Gas Depletion	(40,000)	80.00%	(8,000)	(8,000)	(24,000)
Subtotal		100.00%	(10,000)	(10,000)	(24,000)
Ordinary Loss	(50,000)	31.25%			(50,000)
Capital Loss	(100,000)	62.50%			(100,000)
Charitable Contributions	(10,000)	6.25%			(10,000)
Total		100.00%			($184,000)

Disregarding other applicable limitations, the shareholder would report the following amounts on his/her tax return:

- Interest Income $10,000 Schedule B
- Oil & Gas Depletion ($8,000) Schedule E
- The distributions is a nontaxable return of capital.

The $4,000 50 percent meals & entertainment deduction is only used to determine stock and debt basis and is not reported on the shareholder's tax return.

The shareholder would currently suspend the following loss/deduction items:

- Oil & Gas Depletion ($32,000)
- Ordinary Loss ($50,000)
- Capital Loss ($100,000)
- Charitable Contributions ($10,000)

In this example the shareholder would follow the ordering rules of Treas. Reg. Section 1.1367-1(f) and Treas. Reg. Section 1.1367-2(b):

1. Increase stock basis by income items.
2. Decrease stock basis, but not below zero, by distributions.
3. Decrease stock basis, but not below zero, by nondeductible expenses and oil & gas depletion items.
4. Decrease debt basis, but not below zero, by nondeductible expenses and oil & gas depletion items.

Under IRC Section 1366(d)(2)(A), the shareholder would disallow and suspend to the succeeding tax year the loss/deduction items (which affect the tax liability of the shareholder) in excess of his/her stock and debt basis for the tax year. Since the 50 percent meals & entertainment deduction does not affect the tax liability of the shareholder, the remaining balance of $6,000 [10,000 - 4,000] is only disallowed and will not be suspended to the succeeding tax year.

PROBLEM 9

Ordering Rules / Proration of Suspended Losses - Pre-1996

The shareholder of an S corporation has beginning stock basis of $10,000, beginning debt basis of $100,000, and beginning actual debt of $100,000 for tax year 12/1995. Per the shareholder's Schedule K-1 from the S corporation for tax year 12/1995, the shareholder has flow-through ordinary loss of ($50,000), interest income of $50,000, capital loss of ($100,000), 50 percent meals & entertainment expense deduction of $10,000, oil & gas depletion of $10,000, distributions of $100,000, and charitable contributions of $10,000. The shareholder would compute his/her stock and debt basis in the S corporation and suspended loss/deductions using the ordering rules for tax years beginning before January 1, 1997, as follows:

Description	Schedule K-1 Items	Stock Basis	Debt Basis	Actual Debt	Suspended Loss
Beginning Balance		$10,000	$100,000	$100,000	$0
Interest Income	$50,000	50,000 [1]			
Subtotal		60,000	100,000	100,000	0
50% Meals & Entertainment	(10,000)	(10,000) [2]			
Oil & Gas Depletion	(10,000)	(10,000) [2]			
Subtotal		40,000	100,000	100,000	0
Ordinary Loss	(50,000)	(12,500) [3]	(31,250) [4]		(6,250)
Capital Loss	(100,000)	(25,000) [3]	(62,500) [4]		(12,500)
Charitable Contributions	(10,000)	(2,500) [3]	(6,250) [4]		(1,250)
Subtotal		0	0	100,000	(20,000)
Distributions	(100,000)				
Ending Balance		$0	$0	$100,000	($20,000)

Proration of Currently Suspended Losses

Description	Total Loss	Loss Ratio	Allowed Loss Stock Basis	Allowed Loss Debt Basis	Suspended Loss
Ordinary Loss	($50,000)	31.25%	($12,500)	($31,250)	($6,250)
Capital Loss	(100,000)	62.50%	(25,000)	(62,500)	(12,500)
Charitable Contributions	(10,000)	6.25%	(2,500)	(6,250)	(1,250)
Total	($160,000)	100.00%	($40,000)	($100,000)	($20,000)

Disregarding other applicable limitations, the shareholder would report the following amounts on his/her tax return:

- Interest Income $50,000 Schedule B
- Ordinary Loss ($43,750) Schedule E

- Capital Loss ($87,500) Schedule D
- Charitable Contributions ($8,750) Schedule A
- Capital Gain $100,000 Schedule D (taxable distributions)

The shareholder would currently suspend the following loss/deduction items:

- Ordinary Loss ($6,250)
- Capital Loss ($12,500)
- Charitable Contributions ($1,250)

In this example, the shareholder would follow the ordering rules of Treas. Reg. Section 1.1367-1(e) and Treas. Reg. Section 1.1367-2(b):

1. Increase stock basis by income items.
2. Decrease stock basis, but not below zero, by nondeductible expenses and oil & gas depletion items.
3. Decrease stock basis, but not below zero, by loss/deduction items.
4. Decrease debt basis, but not below zero, by loss/deduction items.

Under IRC Section 1366(d)(2)(A), the shareholder would disallow and suspend to the succeeding tax year the loss/deduction items (which affect the tax liability of the shareholder) in excess of his/her stock and debt basis for the tax year.

PROBLEM 10

Debt Repayment / Debt Repaid in Part - Net Decrease

The shareholder of an S corporation has beginning stock basis of $10,000, beginning debt basis of $50,000, and beginning actual debt of $50,000 for the tax year. Per the shareholder's Schedule K-1 from the S corporation for the tax year, the shareholder has flow-through ordinary income of $50,000 and capital loss of ($80,000). In addition, the S corporation made a repayment to the shareholder of $10,000 on March 15. The shareholder would compute his/her stock and debt basis in the S corporation as follows:

Description	Schedule K-1 Items	Stock Basis	Debt Basis	Actual Debt
Beginning Balance		$10,000	$50,000	$50,000
Actual Debt Repayment			(10,000)	(10,000)
Subtotal		$10,000	$40,000	$40,000
Ordinary Income	$50,000	50,000 [1]		
Subtotal		60,000		
Capital Loss	(80,000)	(60,000) [2]	(20,000) [3]	
Ending Balance		$0	$20,000	$40,000

Computation of Deemed Debt Repayment:

Taxable Portion of Loan Repayment $\frac{50{,}000 - 50{,}000}{50{,}000} \times 10{,}000 = \$0$

Deemed Debt Repayment [Return of Debt Basis] 10,000 - 0 = $10,000

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

Disregarding other applicable limitations, the shareholder would report the following amounts on his/her tax return:

- Ordinary Income $50,000 Schedule E
- Capital Loss ($80,000) Schedule D
- Capital or Ordinary Gain $0 Schedule D (nontaxable debt repayment)

In this example, the shareholder would follow the ordering rules of IRC Sections 1367(a) and 1367(b)(2):

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, by loss/deduction items.

PROBLEM 11

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

The shareholder of an S corporation has beginning stock basis of $0, beginning debt basis of $10,000, and beginning actual debt of $50,000 for the tax year. Per the shareholder's Schedule K-1 from the S corporation, the shareholder has flow-through ordinary income of $50,000 and capital loss of ($20,000) for the tax year. In addition, the S corporation made a repayment to the shareholder of $50,000 at the end of the tax year. The shareholder would compute his/her stock and debt basis in the S corporation as follows:

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

Computation of Deemed Debt Repayment:

Taxable Portion of Loan Repayment $\frac{50{,}000 - 40{,}000}{50{,}000} \times 50{,}000 = \$10{,}000$

Deemed Debt Repayment [Return of Debt Basis] 50,000 - 10,000 = $40,000

Disregarding other applicable limitations, the shareholder would report the following amounts on his/her tax return:

- Ordinary Income $50,000 Schedule E
- Capital Loss ($20,000) Schedule D
- Capital or Ordinary Gain $10,000 Schedule D (taxable portion of debt repayment)

Under Treas. Reg. Section 1.1367-2(d), if a full or partial repayment of debt is made in the tax year, debt basis will be restored before the repayment is made.

In this example, the shareholder would follow the ordering rules of IRC Sections 1367(b)(2)(B) and 1367(a):

1. Restore debt basis first (up to the amount of the actual debt) by the amount of the net increase for year.
2. Increase stock basis by income items.
3. Decrease stock basis, but not below zero, by loss/deduction items.

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

PROBLEM 12

Allocation on a Per Share, Per Day Basis

This example allocates the items of income, loss, and deductions among the shareholders on a per share, per day basis when there was a stock ownership change during the tax year, but the outstanding shares of S corporation stock remained constant (IRC Section 1377 (a)(1)).

On the first day of the taxable year, the S corporation's shareholders owned the following number of shares:

Shareholder	# of Shares
A	40
B	30
C	30
Total	100

On March 15th, the stock ownership of the S corporation changed as follows:

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

On the last day of the taxable year, the S corporation had the following items of income, loss, and deductions.

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

The items of income, loss, and deductions would be computed on a per share, per day basis as follows:

$$\frac{\text{Item of Income, Loss or Deduction}}{\text{Total outstanding shares} \times \text{\# of days in tax year the total shares were outstanding}} = \text{Item of Income, Loss, or Deduction per share per day basis}$$

- Ordinary Income $\dfrac{\$365{,}000}{100 \times 365} = \$10$ per day
- Capital Gain $\dfrac{\$73{,}000}{100 \times 365} = \$2$ per day

- Charitable Contributions $\dfrac{\$36{,}000}{100 \quad x \quad 365}$ = \$1 per day

Revised Date: December 2018