S Corporation Basis

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Understanding S Corporation Basis

Today’s Presenter

- Lawrence Pon
  - Lawrence Pon is a Certified Public Accountant, Personal Financial Specialist, Certified Financial Planner, Enrolled Agent, United States Tax Court Practitioner, and Accredited Estate Planner in Redwood Shores, CA
  - Mr. Pon has been in practice since 1986 and speaks regularly to tax professionals and financial advisors on the latest tax planning and preparation topics nationally.
  - Mr. Pon is a long time member of NAEA and CSEA
  - Mr. Pon teaches Accounting 181 (Individual Income Tax) at College of San Mateo
  - Mr. Pon received his BS in Business Administration from UC Berkeley and MS in Taxation from Golden Gate University in San Francisco

S Corporation Basis

- Basis
- Inside/Outside Basis
- Form 7203
- ERC Requirements
- PPP Loan Forgiveness

Importance of Correctly Tracking Basis

- Basis records must be correctly maintained because basis
  - Limits the amount of corporate loss that can be deducted by shareholders
  - Determines gain or loss when stock is disposed of
  - Determines the amount of tax-free distributions that can be received from the S corporation

Importance of Correctly Tracking Basis

- Form 1040, Schedule E, Part II, Line 28, (e)
  - Check if basis computation is required
- New Form 7203 to be attached to an S-corp shareholder's Form 1040 requires both stock basis and debt basis be tracked and provided to the IRS
- Losses will be disallowed if the shareholder cannot prove they have sufficient basis

Inside and Outside Basis

- Outside basis is the shareholder’s basis in the shareholder’s interest
- Inside basis is the corporation’s basis in its assets

Maintaining Accurate Basis Records

- Keeping track of basis is the shareholder's responsibility
  - Not the corporation's
- Must attach a basis computation to their individual tax return if
  - Report a loss
  - Receive a distribution
  - Dispose of stock
  - Receive a loan repayments from an S corporation
- State tax basis may be different

Attendance Check #1

Please answer the poll in Zoom. If you are unable to enter your answer in the poll you can use the chat or Q&A box.

Calculating Initial Shareholder Basis

- Purchase of shares
  - Initial basis is the cost of the shares
- Shares received when S corporation is capitalized
  - Capitalized under IRC §351
    - Basis of stock generally 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 in the transfer (80% rule)
- C corporation electing S Status
  - Initial basis in S corporation stock = basis in C corporation stock

Calculating Initial Shareholder Basis

- Stock acquired by gift
  - Basis = donor's basis (IRC §1015)
- Stock acquired by inheritance
  - Basis = FMV at date of death or, if elected, alternate valuation date
- Stock received in exchange for services
  - Basis in stock received in exchange for services is measured by the stock's FMV
    - Not by the value of the services
- Stock received in reorganization
  - Basis = basis of stock or securities given up
    - If receive boot, basis increased by gain recognized and decreased by the FMV of the boot

Calculating Initial Shareholder Basis

- Stock basis when corporation is newly formed
  - Transfer $10,000 cash and equipment with a basis of $95,000.
  - Tax free under IRC §351
    - Stock basis = $105,000
  - New fact: Equipment has $20,000 of debt
    - Liabilities reduce basis
    - Stock basis = $85,000
      - Gain at the shareholder level if corporation assumes liability > stockholder's basis in the transferred assets
- Stock basis when C corporation elects S status
  - S election does not change basis
  - C corporation basis does not change from year to year

Adjusting Basis Annually

- Basis Adjustments
  - Increased by
    - Shareholder’s share of nonseparately state income
    - Separately stated items of income
      - Including tax-exempt income
    - Gain
    - Credit items, and
    - Excess of shareholder’s deduction for depletion over the allocable basis in the property subject to depleting
      - Does not apply to oil & gas depletion that is determined at the shareholder level

Adjusting Basis Annually

- Basis Adjustments
  - Decreased by
    - Distributions that are treated as a tax-free return of basis, and
    - Stockholder’s share of nonseparately stated loss
    - Separately state deduction or loss items
    - Expenses that are not deductible and not properly chargeable to a capital account, and
    - The stockholder’s share of depletion on any oil or gas property to the extent such deduction does not exceed the stockholder’s proportionate share of the corporation’s basis in the property

Adjusting Basis Annually

- Nonseparately stated income
  - Income from trade or business activities that is reported on Page 1 of Form 1120S
- Separately stated income items
  - Affect the stockholder's tax liability other than ordinary income
    - Portfolio income
    - Capital gains
    - Rental income
    - Tax-exempt income

Adjusting Basis Annually

- Paycheck Protection Program Loans (PPP)
  - Per CAA, forgiven PPP loan proceeds are excluded from income
    - Proceeds are treated as tax-exempt income
      - Stockholder basis increased by share of forgiven PPP loan
      - Stock basis not increased until the loan is forgiven
  - Borrowing money under PPP does not create stock basis for S corporation shareholders
    - Nor does it provide debt basis

Adjusting Basis Annually

- Paycheck Protection Program Loans (PPP)
  - Example
    - S corp borrowed $80,000 PPP loan to cover eligible expenses
    - Shareholder has $20,000 stock basis
    - Corporation had $40,000 loss in Year 1
      - Could only deduct $20,000
      - $20,000 loss suspended until there is sufficient basis
    - In year 2, corporation granted loan forgiveness
      - Basis increased by $80,000
      - Year 2 loss = $60,000
        - Able to deduct $60,000 + $20,000 = $80,000

Adjusting Basis Annually

- Targeted Economic Injury Disaster Loan Advances (EIDL)
  - Not included in gross income
    - No deduction or basis increase is denied
      - No tax attribute reduced by reason of the gross income exclusion
        - Treat any targeted EIDL advance excluded from income as tax-exempt income
          - Increase stock basis according to normal S corp rules
- Restaurant Revitalization Grants
  - Not included in gross income
    - Treat as tax-exempt income
      - Increase stock basis

Adjusting Basis Annually

- Nondeductible, noncapital expenses
  - Reduce basis
    - Nondeductible portion of meals expense
    - Entertainment expenses
    - Income taxes attributable to the corporation's operations as a C corporation
    - Expenditures that are not deductible because of a credit
      - Disabled access credit
      - Employee retention credit

Adjusting Basis Annually

- Nondeductible, noncapital expenses
  - Nondeductible fines and penalties
  - Nondeductible interest expenses
    - Interest on loan used to purchase tax-exempt securities
  - Nondeductible, noncapitalizable life insurance premiums
  - Losses on sales or exchanges between related parties
  - Expenses and interest relating to tax-exempt securities
  - Illegal payments, bribes, and kickbacks
  - Disallowed losses on distributions of property to shareholders

Adjusting Basis Annually

- Cancellation of debt income
  - Special rules for bankrupt and insolvent taxpayers
    - Bankrupt and insolvent taxpayers exclude debt discharge income from gross income
      - Tax attributes must be reduced
        - Carryover losses of the corporation's shareholders must be reduced
  - Excluded COD income does not increase basis
- Basis cannot be reduced below ZERO
  - Excess is carried forward until there is sufficient basis

Adjusting Basis Annually

- Qualified Business Income Deduction
  - Shareholder may claim a deduction equal to 20% of QBI passed through by the S corporation
    - Deduction calculated at the shareholder level
      - No effect on adjusted basis of the S corporation’s stock

Contribution of Property Example

- Joe owns a rental property
  - FMV = $1,000,000
  - Adjusted basis = $600,000
- Forms a wholly owned S-corp
- Contributes rental to S-corp
  - FMV of sock = $1,000,000
  - Receives only stock in exchange for the rental

Contribution of Property Example

- Gain realized = $400,000 ($1,000,000 - $600,000)
- Joe owns 100% of the S-corp
  - Meets 80% ownership requirement
- No boot received
  - No gain recognized
- Joe's basis in the stock = $600,000 basis in property contributed

Contribution of Property Example

- Same facts, but there is a $300,000 loan on the property
- FMV of stock = $700,000 ($1,000,000-$300,000)
- Gain realized = $400,000 ($1,000,000+$300,000-$600,000)
- Debt < basis, no gain recognized
- Basis in stock = $300,000 ($600,000 - $300,000)

Contribution of Property Example

- Same facts, but Joe joins Kamala's S-Corp
  - Joe will get 70% of the stock worth $700,000 in exchange for the rental
  - Gain realized = $400,000
    - Joe does not meet the 80% ownership requirement
      - $400,000 of gain must be recognized
  - Basis in the stock = $700,000 ($600,000 +$400,000-$300,000)

Attendance Check #2

Please answer the poll in Zoom. If you are unable to enter your answer in the poll you can use the chat or Q&A box.

Ordering and Timing Rules of SH Basis Adj.

- Timing of basis adjustments
  - Normally made at the end of the corporation's tax year
  - First increased by pass-through income
  - Decreased by nontaxable distributions
  - Pass-through items of loss and deduction
  - Increases in basis must be made by corporate year-end to allow the deductibility of losses
- Sale of shares
  - Adjustments to basis effective immediately prior to disposition
  - How is income/loss allocated?
    - Prorata or specific accounting method?

Ordering and Timing Rules of SH Basis Adj.

- Order of adjustments to stock basis
  - Increases
    - Nonseparately stated income
    - Separately stated income
    - Excess of the stockholder’s deduction for depletion over the allocable basis in the property subject to depletion (this does not apply to oil and gas depleting that is determined at the stockholder level)

Ordering and Timing Rules of SH Basis Adj.

- Order of adjustments to stock basis
  - Decreases
    - Distributions that are not includable in the shareholder's income
      - Distributions other than distributions of AE&P
    - Any expense of the corporation not deductible and not properly chargeable to a capital account
      - Fines, penalties, disallowed business meal expenses, and entertainment expenses
    - The shareholder's deduction for depletion on any oil and gas property to the extent such deduction does not exceed the shareholder's proportionate share of the corporation's basis in the property
    - Separately state items of deduction, and
    - Nonseparately stated loss

Attendance Check #3

Please answer the poll in Zoom. If you are unable to enter your answer in the poll you can use the chat or Q&A box.

Adjusting Basis for Property Distributions

- Distributions of property are treated as though the corporation sold the property to the shareholder for its FMV
  - Corporation recognizes gain to the extent the property's FMV exceeds its adjust basis
    - If property's adjust basis exceeds its FMV
      - Loss is not recognized
        - Unless the corporation is making a liquidating distribution
      - The unrecognized loss is a nondeductible, noncapital expense that reduces the shareholder stock basis and the AAA
  - The amount of the distribution is equal to the FMV of the distributed property

Adjusting Basis for Property Distributions

- Example
  - Corporation distributes land with FMV of $60,000 and an adjusted basis of $50,000
  - Shareholder’s basis in stock = $72,000
  - Corporation net income = $41,000
  - Capital gain = $10,000 from distribution of land
  - Shareholder’s stock basis before distribution = $123,000 (72,000 + $41,000 + $10,000)
  - Shareholder’s basis in land = FMV = $60,000
  - Stock basis after distribution = $63,000 ($123,000 - $60,000)

Adjusting Basis for Property Distributions

- Corporate Liquidation
  - Per IRC §331, distributions to a shareholder in complete liquation of an S corporation are treated as proceeds from a sale or exchange of the shareholder's stock
  - Same facts as previous example, except corporation liquidates.
    - Cash of $66,000 and land with FMV of $60,000 distributed to SH
    - Corp's basis in land = $50,000
      - Corporation recognizes $10,000 capital gain
    - Shareholder's basis = $123,000 (as calculated earlier)
      - $41,000 goes on Schedule E
      - $10,000 goes on Schedule D
      - Liquidation calculation
        - Sales price = $66,000 + $60,000 = $126,000
        - Basis = $123,000
        - Recognize $3,000 gain on the liquidation

Distribution of Property Example

- Joe is sole shareholder of S-corp
- S-corp owns building
  - FMV = $1,500,000
  - Adjusted basis = $300,000
  - No loan on property
- Distributes building to Joe
  - Distribution is a deemed sale at FMV
    - Gain recognized = $1,200,000 ($1,500,000 -$300,000)
    - $1,200,000 gain will pass through on K1
      - Will need to pay tax even though no cash

Distribution of Property Example

- Example illustrates why a bad idea to place appreciating asset in an S-corporation
  - If in C corp, subject to double taxation
  - Consider partnership (LLC)
    - Property distributions decrease the recipient partner’s basis by the amount of the partnership’s adjusted basis of the property
    - Property distributions in excess of basis will generally not create capital gain
      - Basis of distributed property in the hands of the partner shall be the lesser of:
        - The partnership’s basis in the distributed property, or
        - The partner’s adjusted basis in the partnership immediately prior to the distribution, less any distributions of cash in the same transaction

Attendance Check #4

Please answer the poll in Zoom. If you are unable to enter your answer in the poll you can use the chat or Q&A box.

Deducting Shareholder Losses to the Extent of Basis

- Losses and deductions not limited at the S corporation level
- Losses pass through to shareholders in full
    - Subject to limitations at the shareholder level
        - Maximum §179 deduction can pass through to shareholders
            - Each shareholder is limited at the individual level to the §179 dollar limitation from all sources combined
- Losses and deductions are limited to basis
- Other limitations
    - At-risk
    - Passive Activity Loss limits
    - Excess business losses

Deducting Shareholder Losses against Debt Basis

- Losses deducted against debt basis after stock basis is depleted
  - An S corp SH obtains debt basis from a debt that is owed by the corp directly to the SH
  - Distributions do not reduce debt basis
- Only direct loans from shareholders provide debt basis
  - Bona fide debt
    - Determined under general federal tax principles and depends upon all of the facts and circumstances
      - Actual economic outlay
      - Was there a genuine intention to create a debit, with a reasonable expectation of repayment, and did that intention comport with economic reality of creating a debtor-creditor relationship?

Deducting Shareholder Losses against Debt Basis

- Tax Court in Litton Business Systems
  - A valid debt may exist even where no formal debt instrument exists
  - The borrower could have obtained the funds from outside sources
  - The borrower's relatively low debt to equity ratio countered any suggestion of thin capitalization
  - The continuous repayments which substantially reduced the balance owed and discharged all interest
  - Was sufficient evidence that the parties' actions complied with the form of the transaction
- Other Tax Court cases concluded there was a bona fide debt even though not evidenced by a formal note

Deducting Shareholder Losses against Debt Basis

- Back to back loans
  - Shareholder borrows funds from an unrelated third party and re-lends to the S corporation
    - Tip: Corporation should not pay the bank loan
    - More IRS scrutiny if from related party
- Circular loans lack economic substance
- Loans guaranteed by shareholder do not create debt basis
  - If shareholder makes payments on loan will obtain debt basis to the extent of the payments

Attendance Check #5

Please answer the poll in Zoom. If you are unable to enter your answer in the poll you can use the chat or Q&A box.

Debt vs. Equity

- Determining whether funds from shareholder are loans or capital contribution
  - Loans to corporation increase shareholder's debt basis
    - Shareholders can receive loan repayments tax-free to the extent of basis in the loan
    - S corporation can deduct interest expense if funds used for business purpose
    - Corporate debt does not qualify for ordinary loss treatment that can apply to worthless stock under IRC §1244
  - IRS can recharacterize debt as equity
    - Possibly more than one class of stock?
    - No interest deduction

Post-termination Transition Period

- S corporation terminates its S election and becomes a C corporation
  - Post-termination transition period (PTTP)
  - This period generally ends one year after the last day of the last S corporation year or the due date for the filing the return for that year, whichever is later
- A shareholder who had insufficient basis to deduct losses while the S election was in effect may acquire additional basis by cash contributions to the capital and use that additional stock basis to deduct losses suspended before the S election terminated
- Distributions to SH during the PTTP are treated as reductions of basis
  - Or gain if the distribution exceeds the SH's basis to the extent of the corp's AAA balance on the last day of the final S corp year

Attendance Check #6

Please answer the poll in Zoom. If you are unable to enter your answer in the poll you can use the chat or Q&A box.

Form 7203

- Form 7203: S Corporation Shareholder Stock and Debt Basis Calculations
  - Since 2018, IRS required shareholders to attach tax basis schedules to their tax returns if certain conditions apply
  - IRS provided a 3-part worksheet in the Schedule K-1 instructions for calculating basis
    - There was no required form or format
  - January, 2022, IRS finalized Form 7203: S Corporation Shareholder Stock and Debt Basis Calculations

Form 7203

- Starting with tax year 2021, Form 7203 is required by shareholders to be filed with their tax returns if certain conditions apply
  - Same conditions since 2018
- Affected shareholders are also required to check a box on Schedule E of their Form 1040 indicating that a basis computation is required

Form 7203

- Form 7203 must be filed by S corporation shareholders who:
  - Are claiming a deduction for their share of an aggregate loss from an S corporation
    - Including an aggregate loss not allowed last year because of basis limitations
  - Received a non-dividend distribution from an S corporation
  - Disposed of stock in an S corporation (whether or not the gain is recognized), or
  - Received a loan repayment from an S corporation

Form 7203

- The form has 3 parts
  - Part I – Shareholder Stock Basis
  - Part II – Shareholder Debt Basis
  - Part III – Shareholder Allowable Loss and Deduction Items

Form 7203

- Part I – Shareholder Stock Basis
  - Reports all changes to stock basis as provided under IRC §1367
    - Capital contributions
    - Schedule K-1 pass-though income (loss) items, and
    - Distributions
  - Distributions in excess of stock basis are reported in this section and flow as capital gain to Form 8949 and Schedule D

Form 7203

- Part II – Shareholder Debt Basis
  - Reports all changes to direct shareholder loans to the corporation
  - Each shareholder loan must be tracked separately
  - Shareholders are required to indicate if the debt is evidenced by a formal note or if it is an open account debt
  - Any gain on loan repayment is reported in this section and flows to other tax forms
    - Formal loan to Schedule D and open account debt to Form 4797

Form 7203

- Part III – Shareholder Allowable Loss and Deduction Items
  - Reports any loss limitations due to basis limitations for the tax year
  - Disallowed losses and carryover amounts are reflected on this form and tracked each year

Attendance Check #7

Please answer the poll in Zoom. If you are unable to enter your answer in the poll you can use the chat or Q&A box.

Recreating Basis for S Corp SH

- 2017, IRS's Large Business and International Division (LB&I) announced its S Corporation Losses Claimed in Excess of Basis campaign
  - Increased reporting requirements
  - New fields added to Form 1120-S
    - Report beginning and ending number of shares held by shareholder
    - Balance of outstanding loans due from the S corporation
    - Form 7203
- Responsibility of each shareholder to track their basis

Recreating Basis for S Corp SH

- Gather as much information as possible
  - All K-1s for each year beginning the year the shareholder acquired the stock, or the year the S election was made
  - Get full copy of 1120-S for each year
    - Change of ownership
    - Review changes in capital stock
    - Review changes in Additional Paid-in Capital
  - Get corporate minutes
  - Get corporate bylaws (plus amendments)
  - Transaction reports from the corporation's financial records
  - Get record of how stock was acquired

Recreating Basis for S Corp SH

- Was the stock acquired as a gift?
- Was the stock inherited?
- Was the stock purchased from another shareholder?
- Was the stock received in exchange for services or property?
- Use the K-1's to track the annual adjustments
- If there are shareholder loans, request copy of loan agreement
  - Review general ledger for amounts and dates of loans and repayments

Recreating Basis for S Corp SH

- What if historical information not available?
  - Make an estimate
  - Add the beginning balances of capital stock and APIC
    - Multiply by shareholder's stock ownership percentage
  - Add the AAA and OAA balances
    - Multiply by the shareholder's stock ownership percentage
  - Method used by IRS Revenue Agents

Recreating Basis for S Corp SH

- What if losses in excess of basis have been deducted?
  - Year closed under statute of limitations?
    - TAM 9304004 and 200619021 and FSA 200230030
      - Suspense account created to track losses claimed in excess of basis from a closed year
        - Balance of the suspense account reduces the stock and debt basis starting in the first open statute year until the suspense account is reduced to zero
          - Balance of suspense account must be reduced to zero before the shareholder is allowed to take tax-free, nondividend distributions or report pass-through losses
            - If there is an NOL carryover, the NOL carryover should be reduced instead of creating a suspense account

ERC and S Corp Basis

- Assume S corporation qualifies for ERC
- ERC is a credit for payroll taxes paid
- Example
  - Adjusted basis = $100,000
  - ERC = $15,000
  - Reduced wage deduction ($15,000)
  - Ending basis = $100,000

ERC and S Corp Basis

- See Page 9 of IRS Practice Unit on Adjustments to Stock Basis for S Corporations (url on resources page)

<u>The Effect of Credits on Stock Basis</u>

Generally, a shareholder may claim credits passed through from an S corporation regardless of the shareholder's stock or debt basis. However, there are two situations in which claiming the credit decreases basis:

1. Credits which require a reduction of an expense, and
2. Credits which require a reduction in the basis of an asset.

An example of the first category is the Research Credit, which requires the taxpayers who elect the Research Credit to reduce the research and experimental expenditures by the amount of the credit. That requirement creates a non-deductible expense at the S corporation level that passes through to the shareholders and the non-deductible expense reduces the shareholder's basis.

Attendance Check #8

Please answer the poll in Zoom. If you are unable to enter your answer in the poll you can use the chat or Q&A box.

Ernest S. Ryder & Assoc v. Comm

- Ernest S. Ryder & Assoc v. Commissioner (TC Memo 2021-88)
  - Tax Court held that the taxpayer had no basis in his S corporation stock as a result of promissory notes by applying the “economic outlay” test
  - Mr. Ryder was a tax attorney and owner of Ryder & Assoc, Inc where he developed and aggressively marketed six tax avoidance schemes to clients
  - $31 million in revenue and zero taxable income
  - Money flowed through 560 different bank accounts
  - $15 million in distributions
    - Paid only $31,000 in income tax
  - IRS noticed company applied to qualify more than 800 ESOPs at the same time
    - Led to an “uberaudit” of the taxpayer and various companies

Ernest S. Ryder & Assoc v. Comm

- Ernest S. Ryder & Assoc v. Commissioner (TC Memo 2021-88)
    - Ryder claimed he had sufficient basis to make the distributions he took from one of the entities as a tax-free return of capital, which derived from promissory notes Ryder signed and made payable to the entity for its stock
    - Tax Court observed that paper promises not backed by cash do not create basis
        - A shareholder makes an “economic outlay” when he incurs a cost or contributes money or property or is otherwise left poorer in a material sense after his contribution
    - Tax Court found that the IRS accurately traced funds through Ryder’s various entities to create the appearance of basis through offsetting book entries, illusory agreements, and loan repayments
    - Tax Court found that the Ryders were liable to close to $16 million in tax on unreported dividend income received during the period

Resources

- Form 7203
  - https://www.irs.gov/pub/irs-pdf/f7203.pdf
  - https://www.irs.gov/pub/irs-pdf/i7203.pdf
- IRS LB&I Concept Unit Knowledge Base – S Corporations
  - https://www.irs.gov/pub/int_practice_units/sco_c_53_04_01_02_02.pdf
    - Adjustments to stock basis

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Q&A

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