

LB&I Concept Unit Knowledge Base – S Corporations

| Library Level | Number | Title |
|---------------|----------|----------------------------|
| Shelf | | Other Flow-Throughs |
| Book | 53 | S Corporation |
| Chapter | 53.4 | Stock & Debt Basis |
| Section | 53.4.1 | Stock Basis |
| Subsection | 53.4.1.3 | Stock Basis Ordering Rules |

| | | |
|-------------------------|----------------------------|---|
| Unit Name | Stock Basis Ordering Rules | |
| Primary UIL Code | 1367.01-00 | Adjustment to Basis of Stock of, and Indebtedness Owing, Shareholders |

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General Overview

Stock Basis Ordering Rules

A shareholder's amount of stock basis and the order in which basis is adjusted are especially important when the shareholder receives a pass-through loss and a distribution in the same year. First, losses and deductions claimed on the shareholder's return may not exceed the shareholder's stock and debt basis. Second, distributions (non-dividend distributions not from accumulated earnings and profits) are tax-free returns of capital, but only up to the amount of a shareholder's stock basis.

Thus, both losses and distributions are subject to basis limitations and both affect stock basis. Because a shareholder can receive pass-through losses and distributions in the same year, ordering rules exist to determine the taxability of distributions as well as the deductibility of loss and deduction items. This practice unit addresses the stock basis ordering rules.

Detailed Explanation of the Concept (cont'd)

| Stock Basis Ordering Rules | |
|--|---|
| Analysis | Resources |
| <p><u>Treatment of Suspended Losses</u></p> <p>When a shareholder's loss or deduction items are disallowed due to basis limitations, they are suspended and carried over to the succeeding taxable year. The suspended prior year losses and deductions are treated as incurred in the current year and are added to the shareholder's current year loss and deduction items.</p> <p>Although suspended losses are treated as incurred in the current year, if the S corporation has income of the same character, it is not netted with the suspended losses for purposes of determining the tax consequences of a distribution in the current year. For example, if the corporation has \$10,000 of ordinary income, that income will increase basis by \$10,000 before distributions, even if the shareholder has a suspended ordinary loss carryover from the prior year.</p> <p><u>Stock Basis Ordering Rule Election</u></p> <p>A shareholder may elect to have basis adjusted in the following order:</p> <ol style="list-style-type: none"> 1. Increased for income items and excess depletion; 2. Decreased for non-dividend distributions; 3. Decreased for items of loss and deduction; and 4. Decreased for non-deductible, non-capital expenses and depletion. <p>Note: This reverses items (3) and (4) of the normal law ordering rules.</p> | <ul style="list-style-type: none"> ▪ IRC 1366(d)(2)(A) ▪ Treas. Reg. 1.1366-2(a)(3)(i) ▪ Treas. Reg. 1.1367-1(g) |

Detailed Explanation of the Concept (cont'd)

| Stock Basis Ordering Rules | |
|--|--|
| Analysis | Resources |
| <p><u>Stock Basis Ordering Rule Election (cont'd)</u></p> <p>Under the normal stock basis ordering rules, non-deductible expenses reduce stock basis after distributions. Non-deductible expenses in excess of stock basis then reduce debt basis and any excess is forgiven and not carried forward.</p> <p>On the other hand, the "cost" of making the election is that any unused non-deductible expenses are carried forward until they are used to reduce stock or debt basis.</p> <p>Once the election is made, the shareholder must continue to use that ordering rule unless the IRS approves a change back to the current law ordering rule.</p> <p> CAUTION: It should be noted that the election can be made on an original return or on an amended return. Therefore, a shareholder can elect to change the stock basis ordering rules during an audit.</p> | <ul style="list-style-type: none">▪ Treas. Reg. 1.1367-1(g)▪ See Examples of the Concept #2 |

Examples of the Concept

Stock Basis Ordering Rules

Examples

Example 1 - Stock Basis Current Law Ordering Rules

Bob, the sole shareholder of an S corporation, has \$25,000 in stock basis at the beginning of the year. During the year, the S corporation incurred a (\$20,000) ordinary loss and made a non-dividend distribution of \$12,000 to Bob.

Using the ordering rules, all of the \$12,000 distribution would be tax-free and (\$13,000) of the (\$20,000) ordinary loss would be allowable to Bob.

| | | |
|-------------------------------------|-----------------|-----------|
| Beginning Stock Basis | 25,000 | |
| Non-Dividend Distribution | <u>(12,000)</u> | Tax Free |
| Stock Basis Before Losses | 13,000 | |
| Ordinary Loss | | Sch. E, |
| (20,000 But Limited to Stock Basis) | <u>(13,000)</u> | Form 1040 |
| Ending Stock Basis | 0 | |
| | | |
| Total Ordinary Loss | (20,000) | |
| Deductible Loss | <u>(13,000)</u> | |
| Suspended Loss Carryforward | (7,000) | |

Bob has an ordinary loss of (\$13,000) and a suspended loss carryforward of (\$7,000).

Examples of the Concept (cont'd)

Stock Basis Ordering Rules

Examples

Example 2 – Stock Basis Ordering Rule Election

Dave, the sole shareholder of an S corporation, has \$15,000 of stock basis at the beginning of the year.

During the year, the S corporation:

- generated a \$4,000 IRC 1231 gain,
- distributed \$17,000 to Dave,
- incurred \$2,500 of non-deductible Travel & Entertainment expenses, and
- incurred a (\$20,000) ordinary loss.

Using the current law ordering rules, Dave's stock basis would be computed as follows:

| | | |
|--|-----------------|----------|
| Beginning Stock Basis | 15,000 | |
| IRC 1231 Gain | <u>4,000</u> | |
| Stock Basis Before Distributions | 19,000 | |
| Non-Dividend Distribution | <u>(17,000)</u> | Tax Free |
| Stock Basis Before Non-Deductibles | 2,000 | |
| Non-Deductible Expenses | <u>2,500</u> | |
| Stock Basis Before Losses and Deductions | <u>0</u> | |
| Ordinary Loss (20,000 But Limited to Stock Basis) | <u>0</u> | |
| Ending Stock Basis | <u>0</u> | |
| Suspended Non-Deductible Expenses | <u>0</u> | (A) |
| Suspended Ordinary Loss Carryforward | (20,000) | |

Examples of the Concept (cont'd)

Stock Basis Ordering Rules

Examples

Example 2 – Stock Basis Ordering Rule Election (cont'd)

If the Treas. Reg. 1.1367-1(g) election is made, stock basis is computed as follows:

| | | |
|---|-----------------|----------|
| Beginning Stock Basis | 15,000 | |
| IRC 1231 Gain | <u>4,000</u> | |
| Stock Basis Before Distributions | 19,000 | |
| Non-Dividend Distribution | <u>(17,000)</u> | Tax Free |
| Stock Basis Before Losses and Deductions | 2,000 | |
| Ordinary Loss (20,000 But Limited to Stock Basis) | <u>(2,000)</u> | |
| Stock Basis Before Non-Deductibles | 0 | |
| Non-Deductible Expenses | <u>(2,500)</u> | |
| Ending Stock Basis | 0 | |
| Suspended Non-Deductible Expenses | <u>(2,500)</u> | (B) |
| Suspended Ordinary Loss | | |
| Carryforward | (18,000) | |

(A) Under the current law ordering rules, non-deductible expenses reduce basis first, but if they exceed basis, they are not carried forward.

(B) If the election is made, the unused non-deductible expenses are carried forward until they are utilized.

In summary, although the shareholder in the current year is allowed to claim a larger loss, the cost of the election requires them to later reduce basis by non-deductibles that would otherwise have gone away.

Index of Referenced Resources

Stock Basis Ordering Rules

IRC 1366(d)(2)(A)

Treas. Reg. 1.1366-2(a)(3)(i)

Treas. Reg. 1.1367-1(f)

Treas. Reg. 1.1367-1(g)

Training and Additional Resources

| Stock Basis Ordering Rules | |
|----------------------------|---|
| Type of Resource | Description(s) |
| Saba Meeting Sessions | <ul style="list-style-type: none">▪ <i>Overview of S Corp Stock Basis - 2014 Centra</i> |
| Issue Toolkits | <ul style="list-style-type: none">▪ Audit Tool - S Corporation Shareholder Loss Limitation Issue Guide▪ Audit Tool – S Corporation Stock & Debt Issue Guide▪ Audit Tool - Stock & Debt Basis Worksheet Tools▪ Audit Tool - FAQs – Basis & Loss Limitations |
| Reference Materials | <ul style="list-style-type: none">▪ <i>Practitioners Publishing Company (PPC) - 1120S Deskbook</i> |

Index of Related Practice Units

| Associated UIL(s) | Related Practice Unit | DCN |
|--------------------------|---|-------------------------|
| 1367.01-00 | <i>Initial Stock Basis</i> | SCO/C/53_4_1_1-01(2016) |
| 1367.00-00 | <i>Adjustments to Stock Basis</i> | SCO/C/53_4_1_2-02(2016) |
| 1367.02-00 | <i>Valid Shareholder Debt Owed by S Corporation</i> | SCO/C/53_4_2_1-04(2016) |
| 1367.00-00 | <i>Adjustments to Debt Basis</i> | SCO/C/53_4_2_2-05(2016) |