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S Corporation Shareholder Basis

Losses Claimed in Excess of Basis



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Campaign Description

S corporation shareholders must track adjustments to their basis in S corporation stock and debt to avoid improperly claiming losses and deductions in excess of basis on their income tax returns.



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Treatment Streams

- Issue Based Examinations
- Soft Letters
- Tax Software Vendor Outreach
- Tax Forms and Publications
- Practitioner/Stakeholder Outreach



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Requirement to Track Basis

- Treas. Reg. § 1.6001-1(a) requires shareholders to maintain permanent books and records to establish losses and deductions reported on their return,
- IRC § 1366(d)(1) provides that shareholders losses and deductions cannot exceed their basis in stock and debt, and
- IRC § 1367 discusses what items adjust shareholders basis.



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Changes to Schedule K-1, Page 2

Schedule K-1 (Form 1120S) 2017

Page 2

This list identifies the codes used on Schedule K-1 for all shareholders and provides summarized reporting information for shareholders who file Form 1040. For detailed reporting and filing information, see the separate Shareholder's Instructions for Schedule K-1 and the instructions for your income tax return.

		Code	Report on
1. Ordinary business income (loss). Determine whether the income (loss) is passive or nonpassive and enter on your return as follows:		N Credit for employer social security and Medicare taxes	} See the Shareholder's Instructions
	<i>Report on</i>	O Backup withholding	
		P Other credits	
Passive loss	See the Shareholder's Instructions	14. Foreign transactions	
Passive income	Schedule E, line 28, column (g)	A Name of country or U.S. possession	} Form 1116, Part I
Nonpassive loss	See the Shareholder's Instructions	B Gross income from all sources	
Nonpassive income	Schedule E, line 28, column (j)	C Gross income sourced at shareholder level	
2. Net rental real estate income (loss)	See the Shareholder's Instructions	<i>Foreign gross income sourced at corporate level</i>	
3. Other net rental income (loss)		D Passive category	} Form 1116, Part I
Net income	Schedule E, line 28, column (g)	E General category	
Net loss	See the Shareholder's Instructions	F Other	
4. Interest income	Form 1040, line 8a	<i>Deductions allocated and apportioned at shareholder level</i>	
5a. Ordinary dividends	Form 1040, line 9a	G Interest expense	Form 1116, Part I
5b. Qualified dividends	Form 1040, line 9b	H Other	Form 1116, Part I
6. Royalties	Schedule E, line 4	<i>Deductions allocated and apportioned at corporate level to foreign source income</i>	
7. Net short-term capital gain (loss)	Schedule D, line 5	I Passive category	} Form 1116, Part I
8a. Net long-term capital gain (loss)	Schedule D, line 12	J General category	
8b. Collectibles (28%) gain (loss)	28% Rate Gain Worksheet, line 4 (Schedule D instructions)	K Other	
8c. Unrecaptured section 1250 gain	See the Shareholder's Instructions	<i>Other information</i>	
9. Net section 1231 gain (loss)	See the Shareholder's Instructions	L Total foreign taxes paid	Form 1116, Part II
10. Other income (loss)		M Total foreign taxes accrued	Form 1116, Part II
	<i>Code</i>	N Reduction in taxes available for credit	Form 1116, line 12
A Other portfolio income (loss)	See the Shareholder's Instructions	O Foreign withholding tax credits	Form 8878
B Involuntary conversions	See the Shareholder's Instructions		
C Sec. 1256 contracts & straddles	Form 6781, line 1		
Miscellaneous investment income	See the Shareholder's Instructions		



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New Stock & Debt Basis Worksheet

Worksheet for Figuring a Shareholder's Stock and Debt Basis

Part I—Shareholder Stock Basis

1. Stock basis at the beginning of the corporation's tax year	1.	_____
2. Basis from any capital contributions made or additional stock acquired during the tax year	2.	_____
3a. Ordinary business income (losses go on Part III)	3a.	_____
b. Net rental real estate income (losses go on Part III)	3b.	_____
c. Other net rental income (losses go on Part III)	3c.	_____
d. Interest income	3d.	_____
e. Ordinary dividends	3e.	_____
f. Royalties	3f.	_____
g. Net capital gains (losses go on Part III)	3g.	_____
h. Net section 1231 gain (losses go on Part III)	3h.	_____
i. Other income (losses go on Part III)	3i.	_____
j. Excess depletion adjustment	3j.	_____
k. Tax-exempt income	3k.	_____
l. Recapture of business credits	3l.	_____
m. Other items that increase stock basis	3m.	_____
4. Add lines 3a through 3m	4.	_____
5. Stock basis before distributions. Add lines 1, 2, and 4	5.	_____

6. Distributions (excluding dividend distributions)	6.	_____
Note. If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.		
7. Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15	7.	_____
8a. Nondeductible expenses	8a.	_____
b. Depletion for oil and gas	8b.	_____
9. Add lines 8a and 8b	9.	_____
10. Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15	10.	_____
11. Allowable loss and deduction items. Enter the amount from Part III, line 13, column (c)	11.	_____
12. Debt basis restoration (see net increase in instructions for Part II, line 8)	12.	_____
13. Other items that decrease stock basis	13.	_____
14. Add lines 11, 12, and 13	14.	_____
15. Stock basis at the end of the corporation's tax year. Subtract line 14 from line 10. If the result is zero or less, enter -0-	15.	_____



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New Stock & Debt Basis Worksheet (cont'd)

Part II—Shareholder Debt Basis

	Debt 1 <input type="checkbox"/> Formal note <input type="checkbox"/> Open account debt	Debt 2 <input type="checkbox"/> Formal note <input type="checkbox"/> Open account debt	Debt 3 <input type="checkbox"/> Formal note <input type="checkbox"/> Open account debt	Total
Amount of Debt:				
1. Loan balance at the beginning of the corporation's tax year				
2. Additional loans (see instructions)				
3. Loan balance before repayment. Combine lines 1 and 2				
4. Principal portion of debt repayment (this line doesn't include interest)	()	()	()	()
5. Loan balance at the end of the corporation's tax year. Combine lines 3 and 4				
Adjustments to Debt Basis:				
6. Debt basis at the beginning of the corporation's tax year				
7. Enter the amount, if any, from line 2				
8. Debt basis restoration (see instructions)				

9. Debt basis before repayment. Combine lines 6, 7, and 8				
10. Divide line 9 by line 3				
11. Nontaxable debt repayment. Multiply line 10 by line 4				
12. Debt basis before nondeductible expenses and losses. Subtract line 11 from line 9				
13. Nondeductible expenses and oil and gas depletion deductions in excess of stock basis				
14. Debt basis before losses and deductions. Subtract line 13 from line 12. If the result is zero or less, enter -0-				
15. Allowable losses in excess of stock basis. Enter the amount from Part III, line 13, column (d)				
16. Debt basis at the end of the corporation's tax year. Subtract line 15 from line 14. If the result is zero or less, enter -0-				
Gain on Loan Repayment:				
17. Repayment. Enter the amount from line 4				
18. Nontaxable repayments. Enter the amount from line 11				
19. Reportable gain. Subtract line 18 from line 17				



New Stock & Debt Basis Worksheet (cont'd)

		(a) Current year losses and deductions	(b) Carryover amounts (column (e)) from the previous year	(c) Allowable loss from stock basis	(d) Allowable loss from debt basis	(e) Carryover amounts
1.	Ordinary business loss					
2.	Net rental real estate loss					
3.	Other net rental loss					
4.	Net capital loss					
5.	Net section 1231 loss					
6.	Other loss					
7.	Section 179 deductions					
8.	Charitable contributions					
9.	Investment interest expense					
10.	Section 59(e)(2) expenditures					
11.	Other deductions					
12.	Foreign taxes paid or accrued					
13.	Total Loss. Combine lines 1 through 12 for each column. Enter the total loss in column (c) on line 11 of Part I and enter the total loss in column (d) on line 15 of Part II					



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Changes to Schedule E Instructions



Department of the Treasury
Internal Revenue Service

2017 Instructions for Schedule E (Form 1040)

Supplemental Income and Loss

Use Schedule E (Form 1040) to report income or loss from rental real estate, royalties, partnerships, S corporations, estates, trusts, and residual interests in REMICs.

You can attach your own schedule(s) to report income or loss from any of these sources. Use the same format as on Schedule E.

Enter separately on Schedule E the total income and the total loss for each part. Enclose loss figures in (parentheses).

Limitation on Losses

If you report a loss from rental real estate or royalties in Part I or you report a loss from a partnership or S corporation in Part II, your loss may be reduced or not allowed this year. You must apply the following rules to your loss.

- Basis rules apply to losses from a partnership or S corporation. See [Basis rules for partnerships](#) and [Basis rules for S corporations](#), later, in Part II.

Basis rules for S corporations. Generally, the deduction for your share of aggregate losses and deductions reported on Schedule K-1 (Form 1120S) is limited to the basis of your stock (determined with regard to distributions received during the tax year) and loans from you to the corporation. The basis of your stock is generally figured at the end of the corporation's tax year. Any losses and deductions not allowed this year because of the basis limit can be carried forward indefinitely and deducted in a later year subject to the basis limit for that year. To figure your aggregated stock basis, you generally can use the Worksheet for Figuring a Shareholder's Stock & Debt Basis in the Shareholder's Instructions for Schedule K-1 (Form 1120S). For more details on the basis rules for S corporations, see the Shareholder's Instructions for Schedule K-1 (Form 1120S).

If you are claiming a deduction for your share of an aggregate loss, attach to your return a computation of the adjusted basis of your corporate stock and of any debt the corporation owes you. For details, see the Shareholder's Instructions for Schedule K-1 (Form 1120S).





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When to Attach the Stock & Debt Basis Worksheet to the Return

- S corporation allocates a loss or deduction item to the shareholder
- S corporation makes a non-dividend distribution to the shareholder
- Shareholder disposes of stock
- S corporation makes a repayment on a loan from shareholder



Computing Basis With Historical Records

To compute basis you need to know –

1. The shareholder's initial cost of the stock and additional paid in capital,
2. The amount of any bona fide loans made directly from the shareholder to the S corporation as well as any loan repayments, and
3. All the items that increase and decrease stock basis since the corporation has been an S corporation or since the shareholder first acquired stock (i.e. Schedule K-1).



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Computing Basis When Historical Records are Not Available

How can you compute the basis for a new client whose basis was never computed and the client does not have the historical records to recompute basis?



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In the Absence of Historical Books and Records?

Consider estimating the shareholders basis using information from the S corporation return.

- Shareholders and their representatives should make every attempt to comply with the laws under IRC §§ 1366(d)(1), 1367 and Treas. Reg. § 1.6001-1(a).
- A basis computation should be maintained from the inception of the S corporation or since the shareholder acquired an interest in the S corporation.



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Computing Basis When Historical Records are Not Available

Estimate initial basis using the earliest S corporation return available

- Beginning Capital Stock
- Beginning Additional Paid-In Capital
- Beginning Accumulated Adjustments Account (AAA)
- Beginning Other Adjustments Account (OAA).



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Example 1 – Estimated Initial Stock Basis Using the Return

Balance Sheet	Beginning	Ending
Capital Stock	45,000	60,000
Additional Paid in Capital	0	0
Retained Earnings	(22,000)	(86,000)



Example 1 – Estimated Initial Stock Basis Using the Return (cont'd)

Schedule M-2	AAA	OAA
1. Balance at Beginning of the Year	(21,000)	1,000
2. Ordinary Income from page 1, line 21		
3. Other Additions		
4. Loss from page 1, line 21	(64,000)	
5. Other Reductions		
6. Combine lines 1 through 5	<u>(85,000)</u>	<u>1,000</u>
7. Distributions other than Dividends		
8. Balance at End of the Year	<u>(85,000)</u>	<u>1,000</u>



Example 1 – Estimated Initial Stock Basis Using the Return (cont'd)

An estimate of stock basis is computed as follows:

Beginning Capital Stock	45,000
Beginning Additional Pd in Capital	<u>0</u>
Beginning Stock Cost	45,000
Beginning AAA and OAA	<u>(20,000)</u>
Estimated Beginning Stock Basis	25,000



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Factors that Distort Estimated Initial Basis

Initial stock basis estimates may not be reliable if:

- The AAA is not computed properly,
- There was a change in shareholders during the years,
- The shareholders contributed uneven amounts to start the corporation, or
- There were disproportionate distributions.



Example 2 – Estimated Initial Stock Basis Using the Return

Balance Sheet	Beginning
Capital Stock	45,000
Additional Paid in Capital	0
Retained Earnings	(22,000)



Example 2 – Estimated Initial Stock Basis Using the Return (cont'd)

Schedule M-2	AAA
1. Balance at Beginning of the Year	(98,000)
2. Ordinary Income from page 1, line 21	
3. Other Additions	
4. Loss from page 1, line 21	(64,000)
5. Other Reductions	
6. Combine lines 1 through 5	<hr/> (162,000)
7. Distributions other than Dividends	
8. Balance at End of the Year	<hr/> (162,000)



Example 2 – Estimated Initial Stock Basis Using the Return (cont'd)

An estimate of stock basis is computed as follows:

Beginning Capital Stock	45,000
Beginning Additional Pd in Capital	<u>0</u>
Beginning Stock Cost	45,000
Beginning AAA and OAA	<u>(98,000)</u>
Estimated Beginning Stock Basis	(53,000)



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Suspense Account

Losses claimed in excess of basis are “suspended” for basis purposes only, as indicated in:

- TAM 200619021
- FSA 200230030
- TAM 9304004



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Example 3 - Initial Basis: Losses in Excess of Basis in Closed Years

Fred is the sole owner of an S corporation. During 2013, the S corporation generated a (\$45,000) loss. Fred's stock basis was only \$15,000 at the start of 2013 and Fred had made no loans to the corporation. Fred deducted the entire (\$45,000) loss on his 2013 Form 1040. Therefore, Fred claimed a \$30,000 loss in excess of his stock and debt basis.



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Example 3 - (cont'd)

In subsequent years, the S corporation had the following income:

2014 - 11,000 Ordinary Income

2015 - 23,000 Ordinary Income

2016 - (4,000) (\$1,000) Ord. Loss & (\$3,000) Rental Loss

In 2014 and 2015, Fred properly reported the S corporation income.

In 2016, Fred received a \$28,000 non-dividend distribution.



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Example 3 - (cont'd)

Fred is a new client and you are preparing his 2016 return.

1. What is Fred's stock basis?
2. Is the \$28,000 distribution taxable?
3. Are any of the ordinary or rental losses deductible?



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Example 3 - (cont'd)

Using the rationale of TAM 200619021, at the end of 2013 Fred has a suspense account of (\$30,000) [\$15,000 basis - \$45,000 2013 loss claimed]. As such, Fred's 2016 stock basis before the \$28,000 distribution is only \$4,000 computed as follows:

2014 Income	11,000
2015 Income	23,000
Suspense Account from 2013	<u>(30,000)</u>
Stock Basis Before Distributions	4,000



Example 3 - (cont'd)

Since there is a \$28,000 distribution, \$24,000 is a taxable distribution in excess of stock basis (LTCG).

Stock Basis Before Distributions	4,000
Distribution	(4,000)
Stock Basis Before Losses	<u>0</u>
Allowable Losses	0

Since there is no basis the \$4,000 loss (\$1,000 in ordinary losses and \$3,000 rental losses) is suspended and carried forward to future years.



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Summary

Required to attach a basis schedule to the return if:

- Allocated a loss or deduction items
- Receives a non-dividend distribution
- Disposes of stock
- Receives a loan repayment from the S corporation



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Summary (cont'd)

To estimate the initial basis for all shareholders, add:

- Beginning Capital Stock
- Beginning Additional Paid-In Capital
- Beginning Accumulated Adjustments Account (AAA) and
- Beginning Other Adjustments Account (OAA)



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Additional Information

- www.irs.gov – Key word: S Corporation
- Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc. and Instructions to Schedule K-1 (1120S)
- www.irs.gov – Key word: Practice Units
 - Losses Claimed In Excess of Basis