



LB&I Process Unit Knowledge Base – S Corporations

Library Level	Number	Title
Shelf		Other Flow-Throughs
Book	53	S Corporations
Chapter	53.5	Shareholder Loss Limitations
Section	53.5.1	Stock and Debt Basis Limitations
Subsection	53.5.1.3	Losses Claimed in Excess of Basis

Unit Name	Losses Claimed in Excess of Basis	
Primary UIL Code	1367.04-00	Losses in Excess of Basis

Document Control Number (DCN)	SCO/P/53_05_01_03-06(2016)
Date of Last Update	04/09/18

Table of Contents

(View this PowerPoint in “Presentation View” to click on the links below)

[Process Overview](#)

[Process Applicability](#)

[Summary of Process Steps](#)

- [Step 1](#) – Verify or Recompute the Shareholder’s Basis
- [Step 2](#) – Losses Claimed in a Closed Statute Year
- [Step 3](#) – Losses Claimed in an Open Statute Year

[Examples of the Process](#)

[Other Considerations / Impact to Audit](#)

[Index of Referenced Resources](#)

[Training and Additional Resources](#)

[Glossary of Terms and Acronyms](#)

[Index of Related Practice Units](#)

Process Overview

Losses Claimed in Excess of Basis

This practice unit addresses whether a shareholder has sufficient basis to claim losses and deductions passed through from the S corporation.

Shareholders may only claim S corporation losses and deductions up to their adjusted basis in stock and debt. IRC 1366(d)(1). Any losses or deductions disallowed due to the limitation are treated as incurred by the corporation in the subsequent taxable year. IRC 1366(d)(2). In other words, shareholders can carry them forward indefinitely, and use them in years with sufficient basis.

This process applies when the shareholder:

1. is allocated a loss or deduction item on Schedule K-1, and
2. deducts all or part of the loss or deduction items on Form 1040 or Form 1041, and
3. does not have sufficient basis to deduct the claimed losses or deductions.

Process Applicability

Losses Claimed in Excess of Basis

Shareholders claiming losses or deductions passed through from an S corporation must have sufficient basis. Use the criteria below to estimate the total basis for all shareholders combined to determine if a potential issue exists.

Criteria	Resources
<ul style="list-style-type: none"> ▪ The S corporation reported Schedule K losses or deductions, which are passed through and reported to the shareholder(s) on Schedule(s) K-1. 	
<ul style="list-style-type: none"> ▪ The estimated beginning stock and debt basis is less than the S corporation's current year Schedule K losses and deductions. Fill out the Audit Tool – Risk Analysis Tool to determine if this criterion is met. 	<ul style="list-style-type: none"> ▪ Audit Tool - Risk Analysis Tool
<ul style="list-style-type: none"> ▪ One or more shareholders claimed a pass-through loss or deduction on their federal income tax returns in excess of the estimated basis. 	
 <p>DECISION POINT: Determine whether or not to pursue the issue. Pursue the issue if the shareholders claimed material losses or deductions on their Forms 1040/1041 in excess of the combined estimated basis.</p>	

Summary of Process Steps

Losses Claimed in Excess of Basis

Process Steps

Determine each shareholder's stock and debt basis to determine the maximum amount of allowable losses and deductions.

Step 1	Verify or Recompute the Shareholder's Basis
Step 2	Losses Claimed in a Closed Statute Year
Step 3	Losses Claimed in an Open Statute Year

Step 1: Verify or Recompute the Shareholder's Basis

Losses Claimed in Excess of Basis

Step 1

Verify or recompute the shareholder's basis computation.

Considerations	Resources
<p>S corporation shareholders are required to maintain adequate books and records to substantiate their basis and adjust that basis each year for the activities of the corporation. Further, individual shareholders are required to attach a basis computation to their return when claiming a loss or deduction, as stated in the Instructions for Schedule E (Form 1040) and the Shareholder's Instructions for Schedule K-1 (Form 1120S).</p> <ul style="list-style-type: none"> ▪ Review the shareholders' returns for the required basis computations and request it if not attached. The basis computation should include all years since the S election or since the shareholder first acquired the stock. ▪ Review the shareholder's stock and debt basis computation: <ul style="list-style-type: none"> - Verify the shareholder's initial stock basis and any subsequent contributions. Consider requesting documentation to support contributions, purchases, gifts or bequests of stock. - Obtain prior years Schedules K-1 information (via the Employee User Portal (EUP), yK-1 and Return Transaction File (RTF) data) and reconcile the increases and decreases to the shareholder's basis computation. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6001-1(a) ▪ IRC 1367 ▪ Form 1040, Schedule E Instructions ▪ Form 1120S, Schedule K-1 Shareholder's Instructions ▪ IRC 1012 ▪ IRC 1367

Step 1: Verify or Recompute the Shareholder's Basis (cont'd)

Losses Claimed in Excess of Basis

[Step 1](#)

Considerations	Resources
<ul style="list-style-type: none">- Inquire about changes in ownership and consider the impact to basis.- Verify the proper stock and debt basis ordering rules are followed and that stock and debt basis are separately tracked.- Verify that any loans from a shareholder to the corporation are bona fide debt running directly from the shareholder to the S corporation.- Verify the shareholder had the funds necessary to lend or contribute to the S corporation. <p>See the Index of Related Practice Units for information on these considerations.</p> <p>Note: The S Corporations & Cooperative Practice Networks recommends inputting the shareholder's basis information into the one of the Stock & Debt Basis Worksheet Tools. These tools follow the proper ordering rules and compute the pro rata allocations, distributions in excess of basis, losses in excess of basis, gain on loan repayment, etc.</p> <p>If the amounts reported are inaccurate or the shareholder did not provide a basis computation, then use the appropriate stock or debt basis worksheets to recompute basis using the shareholder's information, EUP, yK1, LB&I Image Network (LIN), and Integrated Data Retrieval System (IDRS).</p>	<ul style="list-style-type: none">▪ Treas. Reg. 1.1367-1(f)▪ Treas. Reg. 1.1366-2(a)(2)(i) ▪ Audit Tool - Stock & Debt Basis Worksheet Tools

Step 1: Verify or Recompute the Shareholder's Basis (cont'd)

Losses Claimed in Excess of Basis

[Step 1](#)

Considerations	Resources
<p>When historical records are not available to substantiate the shareholder's initial stock basis or the adjustments to basis since making the S election, estimate initial stock basis by taking the earliest S corporation return available and adding:</p> <ul style="list-style-type: none">▪ beginning capital stock,▪ beginning additional paid-in capital,▪ beginning accumulated adjustments account, and▪ beginning other adjustments account. <p>Multiply the total by the shareholder's ownership percentage to arrive at each individual's estimated initial stock basis. See Examples of the Process #1, #2.</p> <p>Note: It is important to establish how and when each shareholder acquired basis in the S corporation as the above estimate may need to be modified as a result of ownership changes. If the estimate appears to be unreasonable based on the facts and circumstances, then consider using zero as the initial stock basis.</p>	

Step 2: Losses Claimed in a Closed Statute Year

Losses Claimed in Excess of Basis

Step 2

Ascertain whether any losses were claimed in excess of basis in a closed statute year.

Considerations	Resources
<p>Stock basis can never be reduced below zero. Therefore, even if a loss is claimed in excess of basis, the stock basis at the beginning of the following year is zero. National Office's position is that if a shareholder claims losses in excess of basis in a year closed by statute, then the shareholder must suspend all future tax-free distributions and losses from the S corporation until the excess losses claimed, but not allowed, are recaptured. FSA 200230030; TAM 200619021 and PLR 9304004.</p>	<ul style="list-style-type: none"> ▪ IRC 1367(a)(2) ▪ FSA 200230030 ▪ TAM 200619021 ▪ PLR 9304004
<p>IRC 7602(a)(1) authorizes the examiner to examine <i>any</i> books, papers, records, or other data which may be relevant or material to determine the correctness of any return, including information from prior years not under examination or closed by statute. IRC 6214(b) allows the Tax Court to determine the correct tax liability for the open year(s) by referring, as necessary, to facts from other years. <i>Lone Manor Farms, Inc. v. Commissioner</i> - 61 T.C. 436, 440-441 (1974); <i>Goldsmith v. Commissioner</i> - T.C. Memo. 2017-20.</p>	<ul style="list-style-type: none"> ▪ IRC 7602(a)(1) ▪ IRC 6214(b) ▪ <i>Lone Manor Farms, Inc. v. Commissioner</i> - 61 T.C. 436 (1974) ▪ <i>Goldsmith v. Commissioner</i> - T.C. Memo. 2017-20
<p>If a taxpayer claims a loss in excess of basis in a closed statute year, then a suspense account is created, pursuant to IRC 1366(d)(2), to track the excess losses. The balance in the suspense account must be reduced to zero before the taxpayer is allowed to take tax-free non-dividend distributions or report pass-through losses. TAM 200619021 explains that the "suspended basis losses claimed in error" should reduce stock basis before current year distributions, non-deductibles and losses and deductions are taken into account.</p>	<ul style="list-style-type: none"> ▪ IRC 1366(d)(2)

Step 2: Losses Claimed in a Closed Statute Year (cont'd)

Losses Claimed in Excess of Basis

[Step 2](#)

Considerations	Resources
<ul style="list-style-type: none">▪ Review the basis computation schedule and identify any years for which the losses and deductions exceed the shareholder's basis.▪ Compare the basis computation to the shareholder's return to determine if the losses claimed in closed statute years exceed basis.▪ Establish or increase the suspense account for any losses and deductions claimed in excess of basis in closed statute years. <p>See Examples of the Process #3.</p> <p>The amount in the suspense account reduces stock and debt basis starting in the first open statute year until the suspense account is reduced to zero.</p> <p>Note: If the shareholder has a net operating loss (NOL) carryover then a suspense account is not created. Instead the NOL carryover is reduced by the improperly claimed prior year losses.</p>	

Step 3: Losses Claimed in an Open Statute Year

Losses Claimed in Excess of Basis

Step 3

Determine whether losses were taken in excess of basis in an open statute year.

Considerations	Resources
<p>The amount of losses and deductions taken by a shareholder for any taxable year cannot exceed the sum of the shareholder's stock basis and the adjusted basis of any S corporation indebtedness owed to the shareholder (debt basis).</p> <p>When stock and debt basis is insufficient, and there is more than one type of loss or deduction item that reduces basis, the amounts allowed as losses or deductions are allocated on a pro rata basis. The pro rata allocation is computed dividing the loss or deduction item by the total loss and deduction items and multiplying the resulting percentage by the available basis.</p> <p>Any losses or deductions disallowed for any taxable year are suspended and carried forward indefinitely until the shareholder has adequate stock or debt basis. The suspended losses retain their character and are carried forward and treated as incurred in the first succeeding year.</p> <p>If the stock is sold or otherwise disposed of, then the suspended losses are no longer carried forward and are lost forever.</p>	<ul style="list-style-type: none"> ▪ IRC 1366(d)(1) ▪ Treas. Reg. 1.1366-2(a)(4) ▪ Treas. Reg. 1.1366-2(a)(5) ▪ IRC 1366(d)(2)(A) ▪ Treas. Reg. 1.1366-2(a)(2)

Step 3: Losses Claimed in an Open Statute Year (cont'd)

Losses Claimed in Excess of Basis

[Step 3](#)

Considerations	Resources
<ul style="list-style-type: none">▪ If the shareholder has a suspense account from step 2, then reduce the shareholder's basis by the lesser of 1) the absolute value of the suspense account, or 2) the basis after the current-year increases.▪ Review the basis computation schedule and identify open statute years for which the losses and deductions exceed the shareholder's basis.▪ Compare the basis computation to the shareholder's return to determine if the losses claimed in open statute years exceed basis.▪ Disallow any losses or deductions in excess of basis, verifying that each loss or deduction item is properly limited on a pro-rata basis. <p>See Examples of the Process #4, #5.</p>	

Examples of the Process

Losses Claimed in Excess of Basis

Description

Example 1 – Estimating Initial Stock Basis Using the Return Resulting in Positive Basis

The balance sheet and Schedule M-1 show the following information:

*Accumulated Adjustments Account (AAA)

**Other Adjustments Account (OAA)

	Beginning	Ending
Capital Stock (Line 22)	45,000	60,000
Additional Paid in Capital (Line 23)	0	0
Retained Earnings (Line 24)	(22,000)	(86,000)
	AAA*	OAA**
1. Balance at beginning of the Year	(21,000)	1,000
2. Ordinary Income from page 1, line 21	0	
3. Other additions	0	0
4. Loss from page 1, line 21	(64,000)	
5. Other reductions	0	0
6. Combined lines 1 through 5	<u>(85,000)</u>	<u>1,000</u>
7. Distributions other than dividends	0	0
8. Balance at end of year	(85,000)	1,000

Examples of the Process (cont'd)

Losses Claimed in Excess of Basis

Description

Example 1 – Estimating Initial Stock Basis Using the Return Resulting in Positive Basis (cont'd)

Based on this information, the estimated beginning stock basis is computed as follows:

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

If there is more than one shareholder, multiply the \$25,000 by each shareholder's ownership percentage to determine each shareholder's estimated initial stock basis. For example, if there are two equal shareholders, then take the estimated beginning stock basis of \$25,000 times 50-percent ownership, which equals \$12,500 of estimated beginning stock basis for each shareholder.

Examples of the Process (cont'd)

Losses Claimed in Excess of Basis

Description

Example 2 – Estimating Initial Stock Basis Using the Return Results in Negative Basis

The corporation made its S election in 2000, but the earliest S corporation return available is 2012. Therefore, the 2012 return is used to estimate initial stock basis. The balance sheet and Schedule M-1 show the following information:

	Beginning	
Capital Stock (Line 22)	45,000	
Additional Paid in Capital (Line 23)	0	
Retained Earnings (Line 24)	(22,000)	
	AAA	OAA
1. Balance at beginning of the Year	(98,000)	0
2. Ordinary Income from page 1, line 21	0	
3. Other additions	0	
4. Loss from page 1, line 21	(64,000)	
5. Other reductions	0	
6. Combined lines 1 through 5	<u>(162,000)</u>	<u>0</u>
7. Distributions other than dividends	0	
8. Balance at end of year	(162,000)	0

Examples of the Process (cont'd)

Losses Claimed in Excess of Basis

Description

Example 2 – Estimating Initial Stock Basis Using the Return Results in Negative Basis (cont'd)

Based on this information, the estimated beginning stock basis is computed as follows:

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

Examples of the Process (cont'd)

Losses Claimed in Excess of Basis

Description

Example 2 – Estimating Initial Stock Basis Using the Return Results in Negative Basis (cont'd)

However, IRC 1367(a)(2) states that basis cannot be decreased below zero. A negative estimated initial stock basis indicates the S corporation generated losses or paid distributions greater than the income it earned in years prior to 2012. Assuming the shareholder's 2012 return and basis computation do not report \$53,000 in suspended losses, a suspense account must be established to track the (\$53,000). TAM 200619021, FSA 200230030 and TAM 9304004.

This example assumes debt basis is zero. If there is debt basis of at least \$53,000, then the beginning debt basis amount would be reduced by the \$53,000 loss instead of establishing a suspense account. Also, if the shareholder has a NOL carryforward of at least \$53,000 from an open statute year, then the NOL is decreased instead establishing a suspense account.

As in Example 1, if there is more than one shareholder, multiply the (\$53,000) by the shareholder's ownership percentage to determine each shareholder's suspense account.

Examples of the Process (cont'd)

Losses Claimed in Excess of Basis

Description

Example 2 – Estimating Initial Stock Basis Using the Return Results in Negative Basis (cont'd)

The suspense account is entered on the Stock Basis Worksheet and the Stock & Debt Basis Workbook as follows:

For more information on the suspense account see the Audit Tool – S Corporation Shareholder Loss Limitations Issue Guide.

Name of Corporation		Shareholder's Name – Stock Basis Computation Worksheet		2012	
STOCK BASIS					
1	Stock Basis at Beginning of Year (cannot be negative)				\$ -
2	Increase for Capital Contribution or Additional Stock Purchase				
	Capital Contribution				\$ -
	Stock Purchase				
3	Increase for Income & Gain Items	2012 Sch. K-1			
	Ordinary Business Income	Line 1	\$ -		
	Separately Stated Income:				
	Net Rental Real Estate Income	Line 2	-		
	Other Net Rental Income	Line 3	-		
	Interest Income	Line 4	-		
	Ordinary Dividends & Royalties	Lines 5a & 6	-		
	Net Short and Long Term Capital Gain	Lines 7 & 8a	-		
	Net Section 1231 Gain	Line 9	-		
	Other Income	Line 10 (A-E)	-		
	Total Income and Gain Items				
	Increase for Tax-Exempt Income	Line 16 (A-B)	-		
	Increase for Excess Depletion Adjustment	Line 17 (R)	-		
	Increase From Recapture of Business Credits	(see IRC §49(a), 50(a), 50(c)(2), & 1371(d))	-		
4	Stock Basis After Increases				
5	Reduced by: "Suspense Account" (Relying on the logic of TAM 200619021)		Beg. of Year	Used in Current Yr	Balance
	Suspended Basis Losses Previously Claimed in Error (Closed by Statute)		(53,000)	-	(53,000)
6	Stock Basis Before Distributions (cannot be negative)				
7	Reduction for Non-Dividend Distributions	Line 16 (D)			Gain
	<i>Note: * Non-Taxable Distributions cannot exceed Ln. 6. If the total distributions exceed Ln. 6, the excess is treated as a deemed sale of S Corporation stock (i.e. LTCG). * If the S Corporation has C Corporation Accumulated Earnings & Profits, distributions in excess of the AAA will be taxed as dividend income & will not reduce stock basis.</i>				
8	Stock Basis Before Non-Deductible Expenses & Depletion (cannot be negative)				
9	Decrease for Non-Deductible Exp., Depletion & Business Credits		Current Year	Applied to Stock Basis	In Excess of Stock Basis

Computation of Shareholder Basis								
Shareholder Name	0				Initials		0	
Taxpayer ID Number	0				Date		1/0/1900	
Income Year	Prior Years							
Schedule 1								
Total Distributive Shares			Basis and Suspended Losses					
1	2	3	4	5	6	7	8	9
Prior Year Suspended Losses	Current Distributive Shares	Total [1+2]	Stock Basis	Debt Basis Schedule 1a	Current Losses Allowed [4+5]	Losses Claimed that Can't be Adjusted	Current Suspended Losses [3-6-7]	Face Amount of Debt Schedule 1a
A. Beginning Balance			0	0				0
B. Additions			0	0				0
C. Subtotal (A+B)			0	0				0
D. Additions:								
- Ordinary Business Income		0	0					
- Net Rental Real Estate Income		0	0					
- Other Net Rental Income		0	0					
- Interest Income		0	0					
- Ordinary Dividends & Royalties		0	0					
- Net ST & LT Gain		0	0					
- Net Section 1231 Gain		0	0					
- Other Income		0	0					
- Tax Exempt Income		0	0					
- Excess Depletion Adjustment		0	0					
- Recapture of Business Credits		0	0					
E. Total Additions		0	0	0				
F. Subtotal (C+E)			0	0				
G. Suspense Account		53,000					53,000	
H. Decrease Basis for Income not reported in closed year			0	0				

Examples of the Process (cont'd)

Losses Claimed in Excess of Basis

Description

Example 3 – Suspense Account

Mary, the sole owner of an S corporation, reported the following income and deduction items on Form 1040 for 2013 (a closed statute year), as reported on Schedule K-1:

Ordinary Income	5,000
Section 1231 Loss	(8,000)
Charitable Contributions	(1,000)

The shareholder's beginning stock and debt basis was zero. As 2013 is a closed statute year, the suspense account is computed as follows:

Beginning Basis	0
Ordinary Income	5,000
Section 1231 Loss	(8,000)
Charitable Contributions	<u>(1,000)</u>
Suspense Account	(4,000)

Examples of the Process (cont'd)

Losses Claimed in Excess of Basis

Description

Example 3 – Suspense Account (cont'd)

The suspense account is entered on the Stock Basis Worksheet and the Stock & Debt Basis Workbook as follows:

For more information on the suspense account see the Audit Tool – S Corporation Shareholder Loss Limitations Issue Guide.

S Corporation Mary – Stock Basis Computation Worksheet 2013					
STOCK BASIS					
1	Stock Basis at Beginning of Year (cannot be negative)				\$ -
2	Increase for Capital Contribution or Additional Stock Purchase				
	Capital Contribution				\$ -
	Stock Purchase				-
3	Increase for Income & Gain Items	2012 Sch. K-1 Line 1	\$ 5,000		
	Ordinary Business Income				
	Separately Stated Income:				
	Net Rental Real Estate Income	Line 2	-		
	Other Net Rental Income	Line 3	-		
	Decrease for Depreciation	Line 17 (N)	-		
	Decrease for Business Credits (see IRC §50(c)(1) & (5))				
10	Stock Basis Before Allowable Losses & Deductions (cannot be negative)				5,000
	Decrease for Loss & Deduction Items	2012 Sch. K-1 Line 1			
	Ordinary Business Loss				
	Separately Stated Loss & Deductions:				
	Net Rental Real Estate Loss	Line 2			
	Other Net Rental Loss	Line 3			
	Net ST & LT Capital Loss	Lines 7 & 8a			
	Net Section 1231 Loss	Line 9	(8,000)	(4,444)	(3,556)
	Other Loss	Line 10 (A-E)			
	Section 179 Deduction	Line 11			
	Charitable Contributions	Line 12 (A-G)	(1,000)	(556)	(444)
	Investment Interest Expense	Line 12 (H)			
	Deductions - Royalty Income	Line 12 (I)			
	Section 59(e)(2) Expenditures	Line 12 (J)			
	Portfolio Income Expenses	Line 12 (K-L)			
	Other Deductions	Line 12 (M-O & S)			
	Foreign Taxes Paid/Accrued	Line 14 (L-M)			
	Total Allocated Loss & Deductions		(9,000)	(4,000)	(5,000)
	Total Allowable Loss & Deductions				(5,000)
12	Stock Basis at End of Year (cannot be negative)				\$ -

	Total Distributive Shares			Basis and Suspended Losses			Debt		
	1 Prior Year Suspended Losses	2 Current Distributive Shares	3 Total [1+2]	4 Stock Basis	5 Debt Basis Schedule 2a	6 Current Losses Allowed [4-5]	7 Losses Claimed that Can't be Adjusted	8 Current Suspended Losses [3-6-7]	9 Face Amount of Debt Schedule 2a
A. Beginning Balance				0	0			0	
B. Additions				0	0			0	
C. Subtotal [A+B]				0	0			0	
D. Additions:									
- Ordinary Business Income		5,000	5,000						
- Net Rental Real Estate Income		0	0						
- Other Net Rental Income	0	0	0						
- Net ST & LT Capital Loss	0	0	0	0	0		0	0	
- Net Section 1231 Loss	0	8,000	8,000	4,444	0	4,444	3,556	0	
- Other Loss	0	0	0	0	0		0	0	
- Section 179 Deduction	0	0	0	0	0		0	0	
- Charitable Contributions	0	1,000	1,000	556	0	556	444	0	
- Investment Interest Expense	0	0	0	0	0		0	0	
- Deductions - Royalty Income	0	0	0	0	0		0	0	
- Section 59(e)(2) Expenditures	0	0	0	0	0		0	0	
- Portfolio Income Expense	0	0	0	0	0		0	0	
- Other Deductions	0	0	0	0	0		0	0	
- Foreign Taxes Paid/Accrued	0	0	0	0	0		0	0	
O. Total Subtractions			9,000	5,000	0		4,000		
P. Subtotal [M-O]					0				
Q. Net Increase (Decrease) [E-J-L-O]			-4,000						
R. Other Stock Reductions and Debt Repayments				0	0			0	
S. Ending Balance (Not Below Zero)				0	0			0	

Examples of the Process (cont'd)

Losses Claimed in Excess of Basis

Description

Example 4 – Allocation of Losses and Deductions

The sole owner of an S corporation has stock basis of \$9,000 at the beginning of the year. During the year, the S corporation generated the following:

Ordinary Loss	(20,000)
Section 1231 Gain	4,000
Cash Charitable Contributions	5,000
Non-Deductible Travel & Entertainment	1,000

Since the items that reduce basis exceed the shareholder's stock basis, the loss is limited to the amount of stock basis. First, the stock basis ordering rules are applied to arrive at stock basis before losses and deductions. Since there is more than one type of loss and deduction item which reduces basis, the amounts allowed as a loss or deduction must be prorated as follows:

Beginning Stock Basis	9,000	
IRC 1231 Gain	<u>4,000</u>	
Stock Basis Before Non-Deductible Exp.	13,000	
Non-Deductible Travel & Entertainment	<u>(1,000)</u>	
Stock Basis Before Losses & Deductions	12,000	
Ordinary Loss	(9,600)	$((20,000 / (20,000 + 5,000)) \times 12,000)$
Cash Charitable Contribution	<u>(2,400)</u>	$((5,000 / (20,000 + 5,000)) \times 12,000)$
Ending Stock Basis	0	

Examples of the Process (cont'd)

Losses Claimed in Excess of Basis

Description

Example 4 – Allocation of Losses and Deductions (cont'd)

The carry over to the next taxable year is:

Ordinary Loss	(10,400)	(20,000) – (9,600)
Cash Charitable Contribution	<u>(2,600)</u>	(5,000) – (2,400)
Total Carryover	(13,000)	(25,000) – (12,000)

Note: Even though this example uses a 100% shareholder, the allocation applies to all shareholders. If a shareholder owns 25% of the S corporation stock, the ordinary income and separately stated items are first allocated 25% to that shareholder. That shareholder then looks to his basis to see if the allocated amount is fully deductible.

Examples of the Process (cont'd)

Losses Claimed in Excess of Basis

Description

Example 5 – Treatment of Suspended Loss Items

Continued from Example 4, during Year 2, the S corporation generated the following:

Ordinary Income	35,000
Section 1231 Loss	(10,000)
Cash Charitable Contributions	1,000
Non-Deductible Travel & Entertainment	5,000

The shareholder's stock basis at the beginning of the year is \$0. Losses suspended in a previous year are treated as being incurred in the next tax year and can only be deducted when basis is increased.

Examples of the Process (cont'd)

Losses Claimed in Excess of Basis

Description

Example 5 – Treatment of Suspended Loss Items (cont'd)

Beginning Stock Basis Year 2		0	
Ordinary Income		35,000	
Stock Basis Before Non-Deductible Exp.		<u>35,000</u>	
Non-Deductible Travel & Entertainment		<u>(5,000)</u>	
Stock Basis Before Losses & Deductions		30,000	
Ordinary Loss	(10,400)		(0 + (10,400))
IRC 1231 Loss	(10,000)		
Cash Charitable Contribution	<u>(3,600)</u>		((1,000) + (2,600))
Ending Stock Basis Year 2		6,000	

Although the Schedule K-1 only shows the current year income items, the shareholder is allowed to take the previously suspended losses. Suspended losses may not be combined with current income amounts, but must be listed on a separate line on the Form 1040, Schedule E, *Supplemental Income and Loss*, or the appropriate schedule when possible. Suspended ordinary loss carryover is not netted with the current year ordinary income when applying the stock basis ordering rules. Treas. Reg. 1.1366-2(a)(3) & (4).

Other Considerations / Impact to Audit

Losses Claimed in Excess of Basis	
Considerations	Resources
<ul style="list-style-type: none">▪ Verify the proper disposal codes are being used for both the S corporation and the shareholder. If an adjustment is made to a shareholder's basis, but no adjustments are made to the S corporation return, the S corporation return is disposed as a "No Change with Adjustments."	<ul style="list-style-type: none">▪ Audit Tool – S Corporation Non-TEFRA Procedures, Statutes & Penalties Issue Guide

Index of Referenced Resources

Losses Claimed in Excess of Basis
IRC 1012
IRC 1366(d)
IRC 1367
IRC 6214(b)
IRC 7602(a)(1)
Treas. Reg. 1.1366-2(a)
Treas. Reg. 1.1367-1(f)
Treas. Reg. 1.6001-1(a)
TAM 200619021
PLR 9304004
<i>Lone Manor Farms, Inc. v. Commissioner</i> - 61 T.C. 436 (1974)
<i>Goldsmith v. Commissioner</i> - T.C. Memo. 2017-20
FSA 200230030
Form 1040, Schedule E Instructions
Form 1120S, Schedule K-1 Shareholder's Instructions

Index of Referenced Resources (cont'd)

Losses Claimed in Excess of Basis

Audit Tool - Risk Analysis Tool

Audit Tool - Stock & Debt Basis Worksheet Tools

Training and Additional Resources

Losses Claimed in Excess of Basis	
Type of Resource	Description(s)
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 - FAQs – Basis & Loss Limitations▪ Audit Tool - S Corporation Non-TEFRA Procedures, Statutes & Penalties Issue Guide▪ Issue Snapshot - <i>Determining a Shareholder's Initial Stock Basis</i>
Reference Materials	<ul style="list-style-type: none">▪ <i>Practitioners Publishing Company (PPC) - 1120S Deskbook</i>

Glossary of Terms and Acronyms

Term/Acronym	Definition
AAA	Accumulated Adjustments Account
EUP	Employee User Portal
IDRS	Integrated Data Retrieval System
LIN	LB&I Image Network
NOL	Net Operating Loss
OAA	Other Adjustments Account
RTF	Return Transaction File

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit	DCN
1367.00-00	<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)
1367.01-00	<i>Stock Basis Ordering Rules</i>	SCO/C/53_4_1_3-03(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)