Chapter 4: S Corporation Shareholder Issues

Corrections were made to this workbook through January of 2005. No subsequent modifications were made.

OVERVIEW

This chapter addresses issues related to reporting items of income and expense for S corporation shareholders, including how to determine allowable losses and other deductions. General rules for S corporation shareholders are different than those pertaining to other pass-through entities.

In 2004, Form 1120S, Schedule K-1 was revised to assist the taxpayer prepare his individual tax return, and assist the IRS with matching pass-through entity information with tax returns.

NEW FORM 1120S, SCHEDULE K-1

6711

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0130

Schedule K-1 (Form 1120S) **2004**

Department of the Treasury
Internal Revenue Service

Tax year beginning ____________, 2004
and ending ____________, 20__

Shareholder's Share of Income, Deductions, Credits, etc.

► **See back of form and separate instructions.**

Part I Information About the Corporation

A Corporation's employer identification number:

B Corporation's name, address, city, state, and ZIP code

C IRS Center where corporation filed return:

D ☐ Tax shelter registration number, if any ____________

E ☐ Check if Form 8271 is attached

Part II Information About the Shareholder

F Shareholder's identifying number:

G Shareholder's name, address, city, state and ZIP code

H Shareholder's percentage of stock ownership for tax year . . . . ____________ %

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	**13**	Credits & credit recapture
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		
5a	Ordinary dividends		
5b	Qualified dividends	**14**	Foreign transactions
6	Royalties		
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss)		
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured section 1250 gain		
9	Net section 1231 gain (loss)		
10	Other income (loss)	**15**	Alternative minimum tax (AMT) items
11	Section 179 deduction	**16**	Items affecting shareholder basis
12	Other deductions		
		17	Other information

* See attached statement for additional information.

For Privacy Act and Paperwork Reduction Act Notice, see Instructions for Form 1120S. Cat. No. 11520D **Schedule K-1 (Form 1120S) 2004**

> **Note.** Form 1120S, Schedule K-1 line numbers referred to in the following discussion are based on the June 23, 2004, draft form shown above.
>
> For purposes of this chapter, "corporations" that are referred to in the examples are S corporations, unless otherwise noted.

ITEMS PASSED THROUGH TO SHAREHOLDERS

S corporations pass through items of income, deductions, and credits to shareholders. Shareholders then report these on their tax returns. Although the text uses the term "individual's return," the taxpayer could be an estate or certain types of trusts.

The S corporation may distribute cash or property to the individual shareholder. A distribution may or may not be taxable, even if the shareholder receives cash or property.

Example 1. John is an S corporation shareholder. In 2003, he receives a Schedule K-1 that reports his share of the corporate ordinary income as $10,000. He also receives a check from the corporation for $4,000. The entire $10,000 is taxable on John's 2003 tax return.

In 2004, the Schedule K-1 reports $8,000 of ordinary income. John also receives a check for $12,000. John only pays tax on the $8,000 unless there are other circumstances (discussed later).

Separately Stated Items and Nonseparately Stated Items

Some items on the Schedule K-1 are separately stated and others are nonseparately stated.

- **Nonseparately stated items** are those based strictly on the ownership percentage of the shareholder.
- **Separately stated items** are based on the contribution of the shareholder or another factor.

For example, the deduction for some charitable contributions is limited to 50% of an individual's AGI. If the contributions were deducted on the corporate return, they would not receive the required limitation. Therefore, charitable contributions are a separately stated item. A list of the most common separately stated items is found on Form 1120S, Schedule K-1. All lines, except line 1, are separately stated items.

Items that do not have special tax treatment are nonseparately stated items. For example, depreciation is a nonseparately stated item. It does not have a special tax treatment nor does it affect any other income or deduction item. The IRC §179 deduction is subject to limitations based on total purchases of qualifying property as well as income. Nonseparately stated items are combined on the front page of Form 1120S and carried to line 1 of Schedule K-1.

ALLOCATION

The S corporation's income, deductions, credits, and other tax attributes are passed through to the shareholder on a per-share, per-day basis. If stock ownership remained the same for the entire year, the pass-through is calculated using each shareholder's percentage of ownership.

Example 2. VDS Corporation has a profit of $50,000 for 2004. During 2004, Robert owns 400 of the 1,000 outstanding shares (40%) and Judy owns the remaining 600 shares (60%). Their ownership percentage does not change at any time during the year.

VDS allocates its income based on the 40/60 ownership. It allocates $20,000 ($50,000 × 40%) to Robert and $30,000 ($50,000 × 60%) to Judy.

If one or more stock ownership changes occurred during the year, the calculation is more difficult. The stock is deemed to belong to the selling/transferring shareholder from the first day of the year through the date of the transfer. Likewise, the buying/receiving shareholder is deemed to own the stock from the day after the transfer through the end of the year. If the S corporation issues stock, income for the day of issuance belongs to the shareholder. To calculate the amounts to pass-through, use the following:

1. **Compute daily income** by dividing the annual income by the number of days in the year (365 except in leap years).
2. **Compute per-share, per-day income** by dividing the daily income by the number of shares outstanding on that day. This amount is recalculated each day based on the number of outstanding shares.
3. **Compute each shareholder's daily income** by multiplying the per-share, per-day income for a particular day by the number of shares owned by each shareholder on that day.
4. **Compute the shareholder's annual income** by adding the daily amounts for the shareholder.
5. **Compute all shareholders' annual income** by repeating the above steps.

Example 3. MAST Corporation has $80,000 of profit in 2004. During 2004, Roxanne owned 400 of the 1,000 outstanding shares (40%) for the entire year. Howard owned the other 600 shares (60%) until June 30 when he sold all of his 600 shares to Sully.

MAST allocates its income based on the per-share, per-day basis. Since the number of outstanding shares did not change during the year, MAST allocates $32,000 ($80,000 × 40%) of the profit to Roxanne. MAST allocates the remaining $48,000 ($80,000 × 60%) profit is allocated between Howard and Sully on a per-day, per-share basis.

Howard is allocated $23,869 (($48,000 ÷ 366 days) × 182 days of ownership).

Sully is allocated $24,131 (($48,000 ÷ 366 days) × 184 days of ownership).

Example 4. PTB Corporation has 400 shares of outstanding stock on January 1, 2004. Sarah owns all shares. On February 1, 2004, Marlene purchases 100 new shares of PTB from the corporation. This reduces Sarah's ownership percentage to 80% (400 ÷ 500). PTB has a profit of $73,200 for 2004.

PTB allocates its income based on the per-share, per-day basis. Since the number of shares outstanding changes during the year, PTB must complete all of the calculation steps.

1. Daily income = $73,200 ÷ 366 days = $200/day.
2. Per-share, per-day income for January 1–January 31 = ($200 ÷ 400 shares) = $.50 per-share, per-day.

   Per-share, per-day income for February 1–December 31 = ($200 ÷ 500 shares) = $.40 per-share, per-day

3.	Sarah's allocation:		
	((400 shares × $.50) × 31 days) =	$ 6,200	
	((400 shares × $.40) × 335 days) =	53,600	
4.	**Sarah's total allocation**		**$59,800**
5.	Marlene's income:		
	((0 shares × $.50) × 31 days) =	$ 0	
	((100 shares × $.40) × 335 days) =	13,400	
	Marlene's total allocation		**$13,400**
	Total of all allocations		$73,200

Shareholder Death. In the year of death, a shareholder's allocation is calculated using the same per-share, per-day basis computation shown above. Income through the day of the shareholder's death is allocated to the deceased shareholder. The income for the remainder of the year is allocated to the new owner of the stock, the beneficiary of the stock, if it passes directly, or to the estate, if the stock goes into the estate.[1] In addition, certain trusts can also be shareholders.

ELECTION TO TREAT TAX YEAR AS TWO SHORT YEARS

An S corporation can elect to use "specific accounting" when a shareholder disposes of her entire stock ownership during the year. An election statement must be attached to the original or amended S corporation tax return. The term "Section 1377(a)(2) Election" should be indicated at the top of each affected shareholder's Schedule K-1.

The election should state that the corporation elects under IRC §1377(a)(2) and Treas. Reg. §1.1377-1(b) to have the rules provided in IRC §1377(a)(1) applied as if the corporation tax year consisted of two years, one year ending on the date of transfer and the other year ending on the normal year-end date. Once made, **the election is irrevocable.**[2]

The corporation and every affected taxpayer must agree to the election in writing. This includes the "selling" and "buying" shareholders, as well as the S corporation. If the percentage of shares owned by other shareholders does not change for the entire year, they are not considered "affected." Consequently, their approval is not required for the special accounting election.

Only one tax return is filed for the year. The election merely "closes" the books at the end of the disposition date and reopens them the following day. The income for the first portion of the year is allocated to the shareholders who owned stock during the first portion of the year. The income for the second portion of the year is allocated to the shareholders who owned stock during the second portion of the year.

Either the "buying" or "selling" shareholder might desire this election. For example, if the sale of an asset occurred prior to the stock sale, and the income for the remainder of the year is expected to be modest, the "buying" shareholder might not want a portion of the profit allocated to him since he did not share in the income.

1. Treas. Reg. §1.1377-1(a)(2)
2. Treas. Reg. §1.1377-1(b)

BASIS

Basis is a very important issue to an S corporation shareholder. The deductibility of losses allocated to a shareholder depends on the shareholder's stock basis. Unfortunately, the stock basis does not appear on the Schedule K-1 and must be tracked by either the shareholder or his tax preparer.

STOCK BASIS

The shareholder's original stock basis depends on how she acquired the stock.

Gift

If the shareholder receives the stock as a gift, generally, the basis of the donor becomes the recipient's basis. If gift tax was paid on the transfer, the stock's basis is increased by the portion of the gift tax related to the stock's appreciation. For example, stock with a basis of $8,000 and a fair market value (FMV) of $10,000 is gifted, requiring a gift tax of $3,000. Since the appreciation of $2,000 represents 20% of the stock's FMV, $600 of the gift tax (20% × $3,000) is added to the stock's basis, resulting in a basis to the recipient of $8,600.

> **Example 5.** Thomas received Greystone stock as a gift from Jane. Jane's basis in Greystone stock immediately before the gift was $15,000 and the stock was worth $40,000. Jane's lifetime gifts are not high enough to require her to pay gift tax on this transfer, but she must file a gift tax return. Thomas's basis in Greystone stock begins at $15,000, which was Jane's basis immediately before the gift.

Inheritance

If a beneficiary receives the stock by inheritance, the FMV of the stock on the date of the decedent's death (or alternative valuation date) becomes the beneficiary's basis. If a beneficiary receives the stock after August 1996, the correct starting basis is the FMV reduced by any amount of Income in Respect of a Decedent (IRD) that is included in the valuation. The executor of the decedent's estate should notify the beneficiary of the correct adjusted valuation of the stock.

> **Example 6.** Daniel received Quartz stock as an inheritance from Carla. Carla's basis in Quartz stock immediately before her death was $15,000 and it had an FMV of $40,000. Carla's estate did not elect the alternative valuation and had $2,000 IRD from Quartz. Daniel's basis in Quartz stock begins at $40,000, which is the stock's FMV on the date of Carla's death. It is reduced by $2,000 IRD resulting in a $38,000 basis.

IRC §351 Transfer

IRC §351 allows a taxpayer to incorporate a business without recognizing income at the time assets are transferred to the corporation. To qualify as a §351 transfer, a transfer must be of one or more shareholders' assets in exchange for stock and no other consideration in the corporation and these same shareholders must own 80% or more of the outstanding corporate stock immediately after the transfer. If more than one person is involved, the transfer of property in exchange for stock must take place at approximately the same time, although it need not occur on the same day.

If the stock is received as a result of the shareholder contributing cash or property to the corporation in exchange for stock, the shareholder's beginning basis depends on whether IRC §351 applies to the transfer.

If §351 does not apply, the shareholder is deemed to have "sold" each asset to the corporation for the asset's FMV and the shareholder recognizes gain or loss accordingly. The FMV becomes the corporation's basis in the assets received and is also the shareholder's beginning basis in the stock received.

If §351 applies, there is generally no gain or loss for the shareholder to recognize. The shareholder's beginning basis in the stock is equal to the cash, plus the adjusted basis of property contributed to the corporation.

The shareholder's beginning basis in either case is reduced by the FMV of any non-stock assets received from the corporation as a result of the transfer. This rarely happens when a corporation is first formed, but can happen when a shareholder is added at a later date.

If a shareholder transfers debt to the corporation as part of an arrangement, the shareholder's beginning stock basis is reduced by the debt transferred. Debt in excess of the shareholder's basis is recognized as income to the shareholder, but does not reduce the shareholder's stock basis since it is already at zero. Any debt that is assumed by the corporation without a valid business reason is considered taxable debt relief to the shareholder. Consequently, the shareholder's stock basis is not reduced by this type of debt relief.

Example 7. Larry contributes $10,000 and a piece of equipment with an adjusted basis of $5,000 and an FMV of $8,000 to MoonSpot Corporation in exchange for 10% of its stock. No one else transfers assets to MoonSpot at approximately the same time. Since Larry's ownership is not greater than or equal to 80%, he is deemed to have "sold" the equipment to MoonSpot for $8,000. Larry recognizes a $3,000 taxable gain. He is then deemed to have paid $18,000 for the stock and has a beginning basis in MoonSpot stock of $18,000.

If Larry also transfers $2,000 of debts to MoonSpot, his basis is reduced by the $2,000, assuming there is a valid business reason for MoonSpot to assume the debts.

Example 8. Donna contributes $32,000 to Firework Corporation for 50% of its stock. At substantially the same time, Sheila contributes $12,000 and a piece of equipment with an adjusted basis of $13,000 and an FMV of $20,000 in exchange for the other 50% of Firework's stock. Since the stock ownership of Sheila and Donna (100%) is greater than or equal to 80%, the exchange qualifies as a §351 transfer. Consequently, Sheila and Donna have no gain or loss to recognize. Donna's beginning basis is $32,000, which is the cash contributed in exchange for her stock. Sheila's beginning basis is $25,000, which is the cash plus the adjusted basis of the contributed equipment.

Stock Purchase

If S corporation stock is purchased from a shareholder, the basis is the amount paid for the stock. Since this transaction occurs outside of the corporation, only the acquiring shareholder knows the initial basis and the corporation may not be able to help with a future basis calculation.

SHAREHOLDER LOANS

A shareholder can increase his basis, for purposes of deducting losses, by either contributing additional capital to the corporation or by making loans to the corporation. Unlike a partnership, where the partner can deduct losses because of loans made by the partnership, an S corporation shareholder can only increase his "loss basis" by making a direct loan to the corporation.

Loans should be in writing, have a reasonable interest rate, and a repayment schedule. Loan payments should be made as outlined in the loan document. If the corporation files bankruptcy, loans have a higher priority and must be paid in full before shareholders receive distributions from the remaining assets. Therefore, a shareholder who has made a loan to the corporation has a right to the loan repayment before he is entitled to any distributions. This puts the shareholder in almost the same position as other creditors.

> **Note.** The IRS does not attempt to recharacterize properly documented loans as wages as often as they recharacterize distributions as wages.

When a corporation liquidates, it pays creditors first. It then distributes any remaining assets pro rata to the shareholders. As a result of this process, the shareholder has two basis items to track; loan basis and stock basis.

Loan Basis

A shareholder's beginning loan basis is the amount of the loan the **shareholder made directly** to the S corporation. The shareholder does **not** have a basis in loans the shareholder **guarantees**, only in loans that shareholder makes directly to the corporation.[3] A shareholder does receive basis when the shareholder pays a debt owed by the corporation.[4]

A shareholder's loan to the corporation that substitutes the corporation's loan from the bank, gives the shareholder basis at the time of the substitution.[5] However, a shareholder-guaranteed bank loan to an S corporation does not give the shareholder basis. As in the *Salem* case, a later change in the note, making the shareholder co-makers, does not change his basis treatment since the change to co-makers does not cancel the corporation's debt.[6]

In the *Hafiz* case, the taxpayers were not permitted to have loan basis when they borrowed money from a bank, and lent the funds to the S corporation with restrictions on the fund's use. The bank documents showed that the specific purpose of the taxpayer's loan was providing funds for the S corporation to purchase motels. The taxpayers could not freely dispose of the funds as they wished. The S corporation made the loan payments directly to the bank. Therefore, the Court ruled the loan was actually a loan from the bank to the S corporation.[7]

With their individual contracts as evidence, each loan by the same shareholder is considered a separate loan. If there are no written instruments for the loans, they are treated as one loan. This could be important when the loan amounts are repaid. More in-depth discussion of this issue occurs later in this text.

> **Caution.** Shareholder loans can have additional tax consequences. Unless handled properly, they can create imputed interest. See the discussion later in this chapter.

ANNUAL BASIS ADJUSTMENTS

Each year, basis adjustments are made to the shareholder's stock and loan bases. Treas. Reg. §1.1367-2(c) requires that shareholders first apply basis increases due to income to loan basis to the extent the loan's basis is not equal to the loan's remaining face amount. The remainder of the income increases stock basis. There is an exception to this when the S corporation has made distributions during the year. This exception is covered later in the chapter.

Basis decreases due to losses and deductions must be applied first to stock basis until it is reduced to zero, then to loan basis.[8]

3. IRC §465(b)(3)
4. *Max Putnam v. Commr.,* 57-1 USTC ¶9200, December 3, 1956; Rev. Rul. 70-50
5. Rev. Rul. 75-144
6. *R.J. Salem v. Commr.,* 75 TCM 1798, TC Memo 1998-63, February 17, 1998
7. *A. Hafiz v. Commr.,* 75 TCM 1982, TC Memo 1998-104, March 16, 1998
8. Treas. Reg. §1.1367-2(b)

ADJUSTMENT ORDERING

There are specific ordering rules for transactions that either increase or decrease stock and loan basis.[9] The ordering rules have changed over the years. The following rules are effective for years after 1996.

1. **Additional contributions to capital** increase stock basis while **additional loans by the shareholder** to the corporation increase loan basis.
2. **The annual ordinary income and all separately stated income items** whether taxable or nontaxable restore loan basis to the face amount of the loan. Any remaining income items increase the shareholder's stock basis.
3. **Shareholder distributions** during the year reduce stock basis first. Once stock basis reaches zero, additional distributions are taxable to the shareholder as a long-term or short-term capital gain, depending on the length of time the shareholder has held the stock. The capital gain is reported on Schedule D.
4. **Separately-stated nondeductible expenses,** such as the 50% nondeductible meals and entertainment costs, and penalties for making late payroll tax deposits, reduce stock basis before reducing loan basis.
5. **Ordinary loss and all deductible separately-stated losses and expenses** are applied to stock basis until the basis reaches zero. Additional loss reduces loan basis. Neither stock basis nor loan basis can fall below zero.

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Note. Income always restores loan basis first and then stock basis, while losses decrease stock basis first and then loan basis.

Basis Increases from Nonseparately Stated Items

Increases include nonseparately-stated income from Schedule K-1, line 1, and all separately-stated income items reported elsewhere on the Schedule K-1. These separately stated income items include items such as:

- Net rental income,
- Interest income,
- Dividends,
- Capital gains,
- Royalty income,
- Net §1231 gains,
- Nontaxable municipal interest income, and
- Any other income shown on the Schedule K-1.

Starting October 12, 2001, nontaxable income from the cancellation of indebtedness no longer increases a shareholder's basis.[10]

9. IRC §1367

10. IRC §108(d)(7)(A) as changed by the Job Creation and Worker Assistance Act of 2002

Basis Decreases from Nonseparately Stated Items

Decreases include nonseparately-stated losses from Schedule K-1, line 1, and all separately-stated deductions or losses reported elsewhere on the Schedule K-1. These separately-stated deduction and loss items include:

- Net rental losses,
- Net §1231 losses,
- IRC §179 deduction,
- Charitable contributions,
- Investment expenses, and
- Investment interest expense.

Decreases from losses and deductions never reduce a shareholder's stock basis below zero. Any losses or deductions that exceed the shareholder's stock basis are applied against the shareholder's loan basis. If the losses and deductions are more than the shareholder's loan basis, any remaining amounts are suspended due to the at-risk limitations (see later discussion of this topic).

Losses always reduce stock basis first. These reduce loan basis only after stock basis has been reduced to zero. The opposite occurs when gains increase basis; gains restore loan basis first. Gains restore stock basis only after loan basis has been restored to the full face amount still due on the loan. See the discussion of an exception to this rule later in the chapter.

A taxpayer can irrevocably elect to decrease stock and loan basis by the ordinary loss and all deductible separately stated losses and expenses **before** decreasing basis by the nondeductible expenses. Once made, this election is binding for all future years, unless the shareholder receives permission from the Commissioner to change. The common term for this is a "Treas. Reg. §1.1367-1(g) election." **Example 9** illustrates this concept.

Practice Pointer: At a glance this election seems to be an easy decision. However, when the at risk rules limit a shareholder to the amount of current deductions for losses, he has to decide if it is better to carry over nondeductible expenses or deductible expenses to the next year. If the shareholder expects income increases, carrying the deductible expenses may produce the better results, and the election should not be made.

Example 9. In 2002, Brian contributed $5,000 to BRI Corporation in exchange for 100% of the corporation's stock. The Schedule K-1 for 2002 shows a nonseparately-stated ordinary loss of $7,000 and nondeductible expenses of $500. Brian made no loans to the corporation nor has he made a Treas. Reg. §1.1367-1(g) election. Brian's stock basis is calculated as follows:

Beginning basis	$5,000
Nondeductible expenses	(500)
Subtotal	$4,500
Deductible loss	(4,500)
Ending basis	$ 0

The remaining $2,500 of ordinary loss is carried over to 2003.

If Brian makes the Treas. Reg. §1.1367-1(g) election in 2002, he calculates his stock basis as follows:

Beginning basis	$5,000
Deductible loss	(5,000)
Subtotal	$ 0
Nondeductible expenses	(0)
Ending basis	$ 0

The remaining $2,000 ordinary loss, as well as the $500 of nondeductible expenses, is carried over to 2003.

In 2003, Brian made an additional $1,000 contribution to BRI Corporation. The Schedule K-1 for 2003 shows a nonseparately-stated ordinary income of $1,250 and nondeductible expenses of $500.

Beginning basis (from 2002)	$ 0
Additions to capital	1,000
Subtotal	$1,000
Income	1,250
Subtotal	$2,250
Deductible loss from 2002	(2,000)
Subtotal	$ 250
Nondeductible expenses from 2002, limited to basis	(250)
Ending basis	$ 0

Brian carries over the remaining $750 of nondeductible expenses to 2004 ($500 from 2003 and $250 from 2002).

Note. See the Appendix of this chapter for shareholder basis computation worksheets.

MULTIPLE STOCK ACQUISITIONS

The gains or losses for the year are allocated on a per-share, per-day basis. A shareholder who acquired stock on more than one date adjusts the basis of each share by that share's gain/loss for the year or portion of the year he owned the shares. If the total number of the S corporation's outstanding shares changes during the year, the per-share, per-day income differs for each group of shares. Since most S corporations do **not** provide two Schedule K-1s (one for each group of shares), the calculation in the following example is a reasonable calculation of the allocable income.

Example 10. Mae purchases 300 shares of Bookend Inc. on October 3, 2003. Her 2003 Schedule K-1 shows total income of $600. Mae's basis in each share increases by $2 ($600 ÷ 300 shares).

On May 26, 2004, Mae purchases 200 more shares of Bookend Inc. from another shareholder. Her Schedule K-1 for 2004 shows overall income of $7,680. Mae's basis in each share increases as follows:

Mae held the 300 shares purchased in 2003 for 366 days in 2004.

300 shares × 366 days = 109,800 share days

Mae held the 200 shares purchased in 2004 for 219 days.

200 shares × 219 days = 43,800 share days

This gives Mae a total of 153,600 share days for the year. She calculates her stock basis as follows:

Income per-share, per-day = total 2004 income ÷ number of share days.

$7,680 income in 2004 ÷ 153,600 share days = $.05 income per share, per day

366 original shares days × $.05 = $18.30 basis increase for each of the original shares.

219 new share days × $.05 = $10.95 basis increase for each of the new shares.

Test

$18.30 × 300 original shares	$5,490
$10.95 × 200 new shares	2,190
Total overall income	$7,680

MULTIPLE LOANS

A shareholder who has more than one loan reduces the basis of each loan by a pro rata portion of the total reduction. The remaining basis of each loan compared to the total bases of all loans determines the pro rata portion.

Example 11. Annette loaned $5,000 (Loan 1) to Galley Corporation in 2002. Her stock basis is zero. Her 2002 Schedule K-1 shows $1,000 of non-separately-stated ordinary loss. This reduces Annette's loan basis to $4,000.

During 2003, Annette made another loan (Loan 2) of $6,000 to Galley, which is properly supported by another loan document. Her 2003 Schedule K-1 for 2003 shows a loss of $2,000. Annette reduces her loan bases as follows:

	Balance Due	Loan Basis
Loan 1	$ 5,000	$ 4,000
Loan 2	6,000	6,000
Total	$11,000	$10,000

Loan 1 reduction = $800 or (($4,000 ÷ $10,000) × $2,000)

Loan 2 reduction = $1,200 or (($6,000 ÷ $10,000) × $2,000)

Annette's new basis for each loan is now:

	Beginning		Ending	
	Balance Due	Loan Basis	Loss	Loan Basis
Loan 1	$ 5,000	$ 4,000	$ 800	$3,200
Loan 2	6,000	6,000	1,200	4,800
Total	$11,000	$10,000	$2,000	$8,000

Loan basis restoration is also pro rata, but it is based on the reductions that take place among the outstanding loans.

Example 12. Continuing with the prior example, Annette's 2004 Schedule K-1 shows $1,000 of income. She increases her basis in the loans as follows:

	Balance Due	Loan Basis	Difference
Loan 1	$ 5,000	$3,200	$1,800
Loan 2	6,000	4,800	1,200
Total	$11,000	$8,000	$3,000

Restoration

Loan 1 restoration = (Basis reduction for Loan 1 ÷ Basis reduction for all loans) × basis increase

Loan 1 restoration = ($1,800 ÷ $3,000) × $1,000 = $600

Loan 1 restoration = ($1,200 ÷ $3,000) × $1,000 = $400

	Beginning		Ending	
	Balance Due	Loan Basis	Gain	Loan Basis
Loan 1	$ 5,000	$3,200	$ 600	$3,800
Loan 2	6,000	4,800	400	5,200
Total	$11,000	$8,000	$1,000	$9,000

LOAN REPAYMENT

An S corporation's principal repayment on a shareholder's loan does not result in income to the shareholder if the loan does not have a reduced basis. However, if the corporation repays some of the principal on the reduced basis loan, some or all of the repayment results in income to the shareholder.

Dividing the loan basis by the loan's unpaid balance determines the percentage of the repayment that is not income. Multiplying this percentage by the loan repayment yields the nontaxable portion of the repayment. The balance of the repayment is income.

$$\textbf{Taxable income} = \textbf{Loan payment} - \left[\frac{\textbf{Loan basis}}{\textbf{Unpaid balance}} \times \textbf{Loan repayment}\right]$$

Example 13. Geraldo loaned $5,000 to Hanger Corporation in 2003. His stock basis is zero. His 2003 Schedule K-1 shows $1,000 of nonseparately-stated ordinary loss. This reduces Geraldo's loan basis to $4,000 or ($5,000 – $1,000).

During 2004, the corporation repaid $2,000 of this loan. Geraldo's Schedule K-1 shows $0 income. Geraldo calculates his income from the repayment as follows:

$4,000 (loan basis) ÷ $5,000 (balance due on loan) = 80%

80% × $2,000 repayment = $1,600 nontaxable

$2,000 – $1,600 = $400 taxable income on repayment

Note. If the S corporation had repaid the entire $5,000, the equation would have resulted in $1,000 of taxable income, which matches the amount of the losses deducted in 2003 by reducing the loan basis.

When there is income in the year a loan is partially or wholly repaid, with reduced loan basis, the shareholder first applies the income to loan basis restoration before the calculating any gain on the repayment.

Example 14. Adolph loaned $5,000 to his S corporation in 2002. His stock basis is zero. His Schedule K-1 for 2003 shows $1,000 of non-separately stated ordinary loss. This reduces Adolph's loan basis to $4,000 ($5,000 – $1,000).

During 2004, the corporation repaid $2,000 of this loan. Adolph's Schedule K-1 shows $500 of income for the year. He calculates his income from the repayment as follows:

Loan basis at end of 2003	$4,000
Increase for 2004	500
Loan basis after applying 2004 income	$4,500

$4,500 ÷ $5,000 (balance due on loan) = 90%

90% × $2,000 repayment = $1,800 nontaxable

$2,000 – $1,800 = $200 taxable income on repayment

The loan basis carried to the following year is reduced by the nontaxable portion of the repayment. The new loan basis is $2,700 ($4,500 – $1,800).

Example 15. Continuing with Adolph from the previous example, his loan basis carried to 2005 is $2,700. The actual loan outstanding is $3,000 ($5,000 loan – $2,000 repayment).

The income from a loan repayment may be either capital gain or ordinary income, depending on the existence of a written obligation.[11] The income is capital gain if there is a written obligation to support the loan. It is long-term or short-term depending on the length of time the note is held by the S corporation. The income is ordinary if there is no written note.

Note. While the IRS has not indicated where this is reported, it appears either Schedule E, Page 2, or Form 4797, Part II, are the likely locations.

When there is more than one loan, the restoration of loan basis first applies entirely to the loan that has a current year repayment, thereby reducing the gain from the repayment. Any remaining restoration is applied pro rata as mentioned earlier.[12]

Example 16. Brooke made two $5,000 loans in prior years to CalcTech. As of December 31, 2003, her basis in these two loans is $2,000 for Loan 1 and $3,000 for Loan 2. Brooke's 2004, Schedule K-1 shows $500 of ordinary income. The S corporation repaid $1,000 of Loan 1.

Before calculating the gain from the repayment, Brooke uses the default rules to restore basis to the loans: $300 basis to Loan 1 and $200 basis to Loan 2. Brooke's taxable gain on the repayment is $540 ($1,000 – [($2,300 ÷ $5,000) × $1,000 repayment)].

Using the special provision mentioned above, Brooke uses the entire $500 of ordinary income to restore her basis in Loan 1 to $2,500. Her gain on the repayment is now $500 or ($1,000 – [($2,500 ÷ $5,000) × $1,000 repayment)].

DISTRIBUTIONS

If the shareholder receives a distribution from the S corporation, the stock basis is restored by any income allocation up to the amount of the current year distribution. This reduces or eliminates any gain from the distribution. He applies any remaining restoration to loans on the normal pro rata basis previously discussed. This is an exception to the normal "income restores debt basis first" rule.

Example 17. As of January 1, 2004, Tina has a stock basis of $0 and a loan basis of $2,500 for the $6,000 loan she made to Tinker Corporation. During 2004, Tina receives a distribution of $2,000. Tina's Schedule K-1 shows an overall income of $3,000 for 2004.

Since Tina receives a distribution during 2004 of $2,000 in excess of her beginning stock basis, she applies the first $2,000 of basis increase from her Schedule K-1 to her stock basis. The distribution of $2,000 decreases Tina's stock basis back down to zero, without generating an excess distribution. She applies the remaining $1,000 of basis increase from her Schedule K-1 to her loan basis, bringing her loan basis up to $3,500 and the principal due to $6,000.

LOSSES AND ALLOCATIONS

Neither the Code nor the Regulations specify how taxpayers should claim the various deductible items if the total is not allowed due to basis limitations. Therefore any reasonable method should be acceptable until IRS or the Courts provide more guidance. One reasonable way is to prorate the allowed amount as a deduction among the different types of losses and expenses on a pro rata basis.

11. Rev. Rul. 64-162

12. Treas. Reg. §1.1367-2

Example 18. Carl invested $5,000 in CATS Corporation. Carl's Schedule K-1 for the year shows $7,000 of nonseparately stated ordinary loss, $1,000 of IRC §1231 loss, and $500 of nondeductible expenses. Prorating his losses results in the following basis adjustments:

Beginning basis	$5,000
Less nondeductible expenses	(500)
Subtotal	$4,500
Less deductible losses	(4,500)
Ending basis	$ 0

Nonseparately stated ordinary loss allowed is $3,937.50. This leaves $3,062.50 nonseparately stated ordinary loss to carry forward to the following year.

($7,000 nonseparately stated ordinary loss ÷ $8,000 total deductible losses) × $4,500 allowed deductions = $3,937.50

IRC §1231 loss allowed is $562.50. This leaves $437.50 of §1231 loss to carry forward to the following year.

($1,000 IRC §1231 loss ÷ $8,000 total deductible losses) × $4,500 allowed = $562.50

Practice Pointer. Since there are no guidelines on the allocation of the deductible losses and expenses, it is important to show reasonableness. One way this can be shown is by choosing a reasonable allocation method and using it consistently.

Reporting Requirements

Generally, all S corporation activity is reported on Form 1120S. Schedule K reports the separately stated items as well as the net income or loss shown on Form 1120-S, page 1. Schedule K-1 is used to report each shareholder's specific allocation. The shareholder then records this information on his Schedule E, Page 2 and other applicable forms. Page 2 of 2004 Schedule K-1 shows where to report most allocated items.

The draft version of the 2004 Schedule K-1 is a totally new format compared to prior years. It is similar in style to a Form W-2. It has boxes for each individual income and deduction item, with instructions on page 2 describing each line and code.

Certain types of income require special treatment. The §179 deduction is one such item. The Schedule K-1 refers shareholders to "See the Shareholder's Instructions."

IRC §179

The election to take the §179 expense deduction is made at the corporate level. The increased allowable amount of $102,000 (beginning in 2004) gives taxpayers greater flexibility. Since the S corporation is a pass-through entity, the actual benefit of the §179 deduction is realized at the shareholder level.

Corporate Level Reporting

Depreciation is included on Form 1120-S, line 14. However, this does not include the §179 deduction. IRC §179 expensing is reported on Schedules K and K-1 as a separately stated item. The Schedule K, line 11 §179 deduction is the amount of the elected §179 expense eligible to be passed through in the current year.

Form 4562 must be completed showing the items that the S corporation is electing to expense under §179. The limitations apply at the S corporation level before the amounts are entered on the Schedule K. The reduction in the amount allowed when qualifying purchases exceed $410,000. However, the taxable income limitation applies at both the S corporation level and the shareholder level. The taxable income limitation at the S corporation level is the S corporation's taxable income **increased** by wages the S corporation paid to shareholders. Any excess amount of §179 expense is carried over to the following year at the S corporation level.

> **Note.** Under current law, the $410,000 limit returns to $200,000 at the end of 2005.

If the corporation was not in existence for the entire year, the maximum amount of §179 deduction is still $102,000. It does not need to be prorated.

> **Practice Pointer.** When reviewing a Schedule K-1 at the shareholder level, it is important to check the taxable business income and the amount of §179 expense. Shareholder's wages are added to Schedule K-1 business income when checking for the reasonableness of the §179 pass-through. If the taxable income does not appear to justify the amount of the §179 expense, the preparer of the Form 1120S should be contacted to verify the information.

INDIVIDUAL LEVEL REPORTING

Schedule E, Part II is used to report various items related to the S corporation. It further divides passive activities and nonpassive activities. Items related to the S corporation that may be included on Schedule E are:

1. Ordinary business income (loss),
2. IRC §179 deduction,
3. IRC §179 recapture,
4. Passive losses and net rental income (loss), and
5. IRC §59(e)(2).

1. ORDINARY BUSINESS INCOME (LOSS)

Ordinary business income (loss) is shown in Box 1 of the Schedule K-1. While this is reported on the individual shareholder's Schedule E, line 28, it may also go in Column g, h, or i depending on whether it is a gain or loss, and whether it is passive or not.

Interest expense related to the purchase of stock in the S corporation is not a Schedule K-1 item, because the interest was paid by the shareholder, not the corporation. However, it is deductible by reporting it on Schedule E, line 28. Whether it is reported in Column g, h or i depends on the nature of the S corporation. This is discussed in more detail later in this chapter.

2. IRC §179 DEDUCTION

Schedule E, Part II, line 28(i) is used to report any §179 deduction taken by the shareholder of the S corporation. The deduction is allowed as a pass-through from the K-1 provided the shareholder meets:

- The income limitation,
- The basis limitation, and
- Does not exceed the $102,000 maximum from all §179 sources.

The shareholder also applies the §179 limitations at her own level. This includes the business income limitation as well as the annual deduction limitation of $102,000. If the shareholder has more than one pass-through business activity, the total amounts passed through may exceed the annual limitation. The entire amount that is passed through reduces the shareholder's basis in the respective pass-through entity, even if is not deductible because of the limitations.

> **Note.** Under current law, the limit returns to $25,000 for tax years beginning in 2006.

3. IRC §179 RECAPTURE

Beginning in 2003, the IRS changed the reporting procedure for the sale of property by an S corporation where the recapture of §179 is an issue. The transaction is reported at the shareholder level with the aid of information provided by the S corporation. Recapture of §179 expense can occur for two reasons.

1. The property's business use dropped to 50% or less, or
2. The property was disposed of.

Business Use Dropped to 50% or Less. If the §179 recapture is the result of the business use of the property dropping to 50% or less, the S corporation must provide the following information to the shareholder via the supplemental information shown on Schedule K-1, line 17.

- The shareholders pro rata share of §179 passed through for the property, and
- The tax year(s) in which the amount was passed through.

At the shareholder level, this amount is reduced by any unused (carryover) §179 expense deduction for this property.

The corporation adjusts the basis of the property by any recapture amount.

> **Note.** Recapture due to the drop in business use is probably rare at the S corporation level. It may happen when property is used for business and later converted to investment property by the S corporation. A vehicle used more than 50% in the business would not be affected by this rule since the vehicle is considered used 100% for business with any personal use charged to the shareholder as compensation or a dividend.

Disposition of Property. The second type of recapture happens when the S corporation disposes of property which the corporation claimed as a §179 deduction. Under the new procedures, starting with 2003 tax returns, the S corporation **does not** prepare the Form 4797 to report the sale of the property.

> **Caution.** This is a major change from the prior reporting method.

The shareholder's pro rata share of the disposition is reported directly on the shareholder's Form 4797. The S corporation is responsible for providing the following information to the shareholder on Schedule K-1, line 17:

- Description of the property.
- Date the property was acquired.
- Date of disposition of the property.
- Shareholder's pro rata share of the gross sales price.
- Shareholder's pro rata share of the cost or other basis of the property plus the expense of sale. If the property was subject to any adjustments due to investment credits, the basis may have to be adjusted.[13]
- Shareholder's pro rata share of the depreciation allowed or allowable, excluding any §179 expense deduction.
- Shareholder's pro rata share of §179 expense deduction passed through for the property and the corporation's tax year(s) from which it was reported. The amount used by the shareholder may be adjusted by the amount of §179 used by the shareholder, or a change in the interest of the shareholder.
- An indication whether the disposition involved a casualty or theft.
- If this is an installment sale, the information needed to complete Form 6252.

13. IRC §50(c)

Prior Reporting Method. When the S corporation prepared Form 4797 to report the sale of this property, it only showed the depreciation allowed or allowable on the property. The S corporation did not show the §179 expense as "depreciation" on Form 4797. This is different from the reporting by individuals. This different reporting exists because the S corporation did not know if the shareholder was able to use the §179 pass-through.

If the recapture is due to a disposal of the property, the shareholder has to examine her tax return for the year of the original pass through to determine if she was able to use the §179 expense. If the shareholder claimed the §179 expense, then she must report the deducted §179 expense as depreciation for purposes of computing gain or loss on Form 4797. If the shareholder did not deduct the §179 expense, she does not have to include this amount as depreciation on Form 4797. If the shareholder claimed some, but not all of the §179 expense, then she must report the amount claimed as additional depreciation.

In all three cases, the shareholder decreases her basis in the S corporation at the time the deduction is passed through regardless of whether it was used. By using the correct amount of §179 as depreciation to compute the gain or loss, the correct adjustment will be made.

Example 19. In 2003, DG Corporation purchased equipment for $30,000. DG Corporation elected a §179 expense of $24,000 and correctly passed it through to its shareholders, claiming $857 of depreciation on the remaining $6,000 of basis. In 2004, DG Corporation sold the property for $28,000 and claimed an additional $735 of depreciation.

DG Corporation must pass the information to the shareholders. Cole is a 40% shareholder of DG and his Form 4797 shows the following:

Sales price ($28,000 × 40%)		$11,200
Cost ($30,000 × 40%)	$12,000	
Depreciation allowed or allowable ($25,592 × 40%)	(10,237)	
Adjusted basis	$ 1,763	(1,763)
Gain on sale		$ 9,437

Cole's 2004 Schedule K-1 shows his share of the amounts listed. His K-1 must also inform him that $9,600 ($24,000 × 40%) of §179 was passed through to him in 2003 in relation to this asset.

Due to electing §179 for other assets in 2003, Cole elected to only use $4,800 of the §179 expense that was passed through on his 2003 Schedule K-1. Since Cole did not use the entire §179 expense in 2003, he reports the depreciation allowed or allowable as $5,437 ($637 of depreciation and $4,800 of §179).

Sales price		$11,200
Cost	$12,000	
Depreciation allowed or allowable	(5,437)	
Adjusted basis	$ 6,563	($ 6,563)
Gain on sale		$ 4,637

Example 20. Jammer Corporation placed in service $20,000 of property eligible for the §179 expensing. Jammer's business loss for the year is $30,000, which includes $65,000 of deductions for wages paid to shareholders.

Jammer's taxable income for the §179 limitation is $35,000 ($ –30,000 business loss + $65,000 shareholder wages). Therefore it can elect and pass through the entire $20,000 of §179 expense.

Jammer has two 50% shareholders. Sally receives $65,000 of wages and Rhonda receives no wages.

Sally receives a Schedule K-1 reporting $15,000 of business loss and a Form W-2 from the S corporation showing $65,000. This results in $50,000 of net business income, which is adequate to substantiate the Schedule K-1 pass through of the $10,000 of §179 deduction.

Rhonda receives a Schedule K-1 with $15,000 of business loss and no Form W-2 from the S corporation. This results in $15,000 of business loss, which does not appear to substantiate the Schedule K-1 pass-through of the $10,000 of §179 deduction. Unless the S corporation has provided information showing its calculation, such as a copy of the Form 1120S, the taxpayer or tax professional must investigate the issue before claiming the §179 deduction.

Example 21. Emma is a 40% shareholder in three corporations. During 2002, when the §179 limitation was $24,000, each corporation properly elected, calculated, and passed through the maximum §179 expense. Emma's Schedule K-1 from each corporation properly reflected her $9,600 of §179 expense for a total of $28,800 ($9,600 × 3 Schedule K-1s).

Since the 2002 annual limitation was $24,000, Emma had to choose which amounts to deduct from the corporations. Emma must still reduce her basis in each corporation by $9,600 because of the §179 expense. This is true even though she cannot use $4,800 of the §179 currently, or use it to reduce her income in the future. She will benefit from the unused $4,800 when the asset is sold or disposed of by the applicable S corporation, since it will result in a smaller gain or larger loss. If she disposes of her stock interest prior to the corporation disposing of the applicable asset, she loses the $4,800 future benefit.

Observation. Emma, may want to encourage the corporation management to consult with her before making the §179 elections since she might lose the deduction.

4. PASSIVE LOSSES AND NET RENTAL INCOME (LOSS)

Passive losses and net rental income (loss) are carried to Form 8582 and are subject to the passive loss rules of IRC §469. The losses allowed in the current year are reported on Schedule E, page 2. Losses that are not allowed in the current year are carried forward to the following year. Form 8582 worksheets should be sent with the taxpayer's tax return to allow the IRS to trace these amounts.

Prior year losses, suspended due to the passive loss rules, are brought forward to Form 8582 and merged with the current year's losses. If the amount of losses allowed under the passive rules in the current year exceeds the amounts shown on the Schedule K-1, the excess losses are deemed to be from the prior year and are reported separately on the Schedule E, page 2 as a "PYA" (prior year amount).

5. IRC §59(e)(2) AMORTIZATION OF CERTAIN INTANGIBLES

IRC §59(e)(2) expenditures are reported on Schedule E, page 2. The taxpayer must make a decision regarding these expenses.

He can elect to **amortize these expenses over a period of years without an AMT adjustment.** This election is made on Form 4562, Page 2. Circulation expenditures have an amortization period of three years. Research and experimental expenditures and mining exploration and development costs have an amortization period of 10 years. Intangible drilling and development costs have a five-year amortization period.

Alternatively, they can be **deducted in the current year, which requires an AMT adjustment** for both the current year and future years in the normal amortization period.

Example 22. Dick's Schedule K-1 shows a §59(e)(2) expense of $5,000 for research and experimental expenditures. If Dick elects to amortize the expenses, he deducts $500 each year for 10 years starting with the current year. He does not have an AMT adjustment.

Alternatively, if Dick does not elect to amortize the expenses, he has a $5,000 deduction in the current year and an AMT positive adjustment for $4,500. This is the amount that would not have been deductible had he amortized the expense. In the second through tenth years, Dick does not have a regular tax deduction, but he has an AMT negative adjustment of $500 each year.

IRS MATCHING

The IRS is making a concerted effort to match the information reported on the Schedule K-1 with the information reported on the shareholder's tax return, specifically the Schedule E. This was evidenced by a new question appearing on Schedule E in 2003.

Schedule E, Part II, line 27, asks the "Yes" or "No" question, "Are you reporting losses not allowed due to the at-risk or basis limitations, passives losses not reported on Form 8582, *Passive Activity Loss Limitations* or unreimbursed partnership expenses?" If the answer is "yes," the instructions describe the proper reporting of these items. The reporting is designed to separate the current year amount shown on the K-1 from the adjustments to those amounts. The instructions identify two instances where there may be differences and the proper way of handling those differences.

1. Suspended losses not allowed in a prior year due to the at-risk or basis limitations, but allowed in the current year, are entered on a separate line under line 28(h). They should be identified by the letters "PYA" (prior year amount) in line 28(a). This enables the IRS to insure that the current amounts on the K-1 have been properly recorded. Form 6198, *At-Risk Limitations* should also be attached when applicable.
2. Suspended passive losses not reported on Form 8582, but allowed in the current year, follow the same procedure outlined above using line 28(f) to separate the numbers. "PYA" should again appear in column "a."

INDIVIDUAL SHAREHOLDER ISSUES

LOANS TO OR FROM THE SHAREHOLDER

Loans between the shareholder and the corporation can have unexpected tax consequences depending on the structure of the transaction. A formal loan agreement helps substantiate the loan in case of an IRS audit. This agreement should contain:

- The date of the loan,
- The amount of the loan,
- The interest rate,
- A repayment schedule, and
- A list of property which is collateral for the loan, if applicable.

In essence, it should include the same items required for a bank loan. Failure to properly document the loan could result in the IRS viewing the loan as a contribution of capital, or the repayment as a distribution.

If an adequate interest rate is not included in the contract, the calculation of imputed interest is required.[14] In some cases, there is an exception to this requirement where the aggregate loan amount with a shareholder is not over $10,000. This exception is discussed later in the chapter.

14. IRC §7872

Each calendar year the loan remains unpaid, imputed interest is deemed to be paid by the borrower to the lender and then transferred from the lender to the borrower.

If the shareholder makes a loan to the corporation without adequate interest, the imputed interest is treated as if:

1. The corporation paid the interest to the shareholder, thereby giving the corporation an interest expense,
2. The shareholder received the interest income, which he must report on Schedule B,
3. The shareholder gave the money to the corporation as a contribution to capital, which increases his stock basis, and
4. The corporation received a contribution to capital.

This is a circular transaction with some steps resulting in income or deductions, and others without tax consequences. The amount of interest is computed using the applicable federal rate (AFR). AFR is discussed later.

Example 23. Sherry made a no interest loan of $50,000 to Cantor Corporation on January 1. No payments were made during the year. The annual blended rate was 4%. The imputed interest for the year is $2,000. Cantor Corporation deducts $2,000 as interest expense. Sherry reports $2,000 of interest as income. Sherry is treated as making a $2,000 contribution to Cantor's capital which increases her stock basis. Cantor increases capital stock or paid-in-surplus by the $2,000. The outstanding loan balance remains at $50,000.

If the corporation made a loan to the shareholder without adequate interest, the imputed interest is treated as if:

1. The shareholder paid interest to the corporation. This is treated as interest expense to the shareholder. The interest may be deductible under the tracing rules, depending on what the shareholder did with the original loan proceeds.
2. The corporation received the interest income, which is reported as taxable income.
3. The corporation made a distribution to the shareholder.

These "distributions" are normally classified as distributions by the corporation in an S corporation.

If the loans are deemed to be compensation-related loans between an employer and an employee, the imputed interest may be classified as wages. This gives the corporation a wage deduction. The corporation is required to withhold FICA taxes (or RRTA) and pay proper payroll taxes.

The shareholder lowers her basis in the S corporation by these distributions. If the distributions are reported as wages, the wages are reported as additional income as shown on her Form W-2.

Practice Pointer. The way the loan is treated from the beginning may affect the bad debt deduction if the corporation liquidates before the loan is repaid. Corporation-shareholder loans are normally treated as short-term capital losses on Schedule D. Compensation-related loans are deductible as a business bad debt for an employee on Form 2106, *Employee Business Expenses,* and then carried to Schedule A as a 2% miscellaneous itemized deduction.

Example 24. Waffle Corporation made a $50,000 no interest loan to Bernie on January 1, 2003. Bernie used the loan to take expensive vacations. No loan payments were made during the year. The annual blended rate is 4%. The imputed interest for the year is equal to $2,000. Bernie cannot deduct this interest expense since he used the proceeds for personal purposes. Waffle reports $2,000 of interest income and also reports the $2,000 paid to Bernie as either a distribution or wages. Bernie lowers his basis by $2,000, or he reports $2,000 of additional wage income.

Types of Loans

The calculation of the imputed interest depends on the type of loan made. There are two types of loans that typically have imputed interest:

1. Demand loans, and
2. Term loans.

Demand Loans. A demand loan is payable in full at any time upon the demand of the lender. Demand loans also include loans of indeterminable length. The interest rate required for the imputed interest computation is the rate in effect for each payment period. The payment periods end every June 30 and December 31. The rate used is the short-term semi-annual applicable federal rate (AFR). The rate for a new loan is the rate in effect for the month of the loan. This rate continues to be used through the end of the period.

> **Note.** The AFRs change monthly and are released by the IRS in Revenue Rulings. They can be found at www.irs.gov by searching "AFR." The rates are also shown in the Rates and Tables Chapter.

Each succeeding January and July, the new semi-annual AFR for that January and July is used through the end of the period (the following June and December, respectively). Imputed interest is added to the outstanding loan balance every June 30 to compute the imputed interest for the remainder of the year.

Example 25. Linda made a demand loan to her corporation on September 1, 2003. The semi-annual short-term rate for September, 2003 was 1.51%. This rate is used for the period from September 2003 through December 2003. The semi-annual short-term rate for January 2004 is 1.43%, which is used for the period January 1 through June 30. The semi-annual short-term rate for July 2004 is 2.25%, which is used for the period July 1 through December 31.

The imputed interest on a demand loan is the difference between the interest on the loan using the short-term semi-annually compounded AFR, and the interest using the rate included in the contract. This is $0 if no interest was included in the contract. The amount of the imputed interest can be computed using either the exact method or the approximate method.

The **exact method** uses a daily compounding and is more complex.

The **approximate method** can be used for below-market loans totaling $250,000 or less. The approximate method computes the interest amount by:

1. Multiplying the loan amount by the applicable semi-annual rate, which results in an annual amount, and then
2. Multiplying this result by 6 and dividing by 12 results in six months of interest.

As mentioned previously, the interest is added to the loan amount prior to computing the interest for the second semi-annual period of the calendar year. If the loan is not outstanding for the entire six-month period, then the formula changes by substituting the "6" with the number of months during which the loan did exist in the period.

When a loan amount outstanding on the first day of the year does not change throughout the year, a blended rate can be used to determine the interest for the year. The blended rate is published with July AFRs. The blended rate produces the same results as the semi-annual rates with semi-annual compounding. This rate is 1.98% for 2004.

Example 26. Oliver made a demand loan of $100,000 on September 1, 2002. No repayments were made during 2002. The semi-annual short-term rate for September, 2002 is 2.02%. Using the approximate method, the interest for the period from September 1, 2002 through December 31, 2002 is:

$$\$673 = (\$100{,}000 \times 2.02\%) \times (4 \text{ months} \div 12 \text{ months})$$

This interest is considered paid on December 31, 2002, and Oliver is considered to have contributed this amount to the capital of the corporation.

On March 1, 2003, $25,000 was repaid. The remaining $75,000 is still outstanding on December 31, 2003. The semi-annual short-term rate for January 2003 is 1.80%, and for July 2003 is 1.23%. Oliver's imputed interest is computed as follows:

Interest for January 1 to February 28, 2003 ($100,000 × 1.80%) × (2 months ÷ 12 months)	$ 300.00
Interest for March 1 to June 30, 2003 ($75,000 × 1.80%) × (4 months ÷ 12 months)	450.00
Total imputed interest for first six months	$ 750.00
Interest from July 1 to December 31, 2003 is computed on $75,750 ($75,000 outstanding on July 1, 2003 + 750)	
Interest from July 1 to December 31, 2003 ($75,750 × 1.23%) × (6 months ÷ 12 months)	465.86
Total imputed interest for the full year of 2003	$1,215.86

Additional money borrowed is treated as a new loan. Each repayment is treated as a payment on the first loan until it is paid off. Future loan repayments are applied towards the second loan, and so on.

The deemed transfer occurs on December 31 of the calendar year regardless of the tax year of the entity. If the loan is paid prior to the end of the calendar year, the imputed interest is considered to be paid at the time the loan is repaid.

Term Loans. A term loan is any loan which is not a demand loan. A term loan is considered a below-market loan if the amount of the loan exceeds the present value of all loan repayments under the loan, calculated as of the date the loan is made using a discount rate equal to the AFR. The deemed interest is treated as original issue discount (OID) equal to the difference between the amount loaned and the present value of the payments required to be made over the term of the loan.

The present value can be computed by using the following formula:

$$\frac{\text{Total payments to be received}}{\left(1 + \left(\frac{\text{rate}}{\text{frequency}}\right)\right)^{\#\text{ of periods}}}$$

The deemed transfer from the lender to the borrower of this excess occurs at the time the loan is made. The transfer of the interest from the borrower to the lender occurs over the life of the loan using the OID rules.

If a formal contract does not exist to substantiate the loan, an IRS examination could recharacterize the payments.

Example 27. On July 1, 2002, Redford Corporation made a $100,000 interest-free three-year loan to Frank with no payments due until July 1, 2005. The July 2002 AFR for short-term semi-annual compounding was 2.82%. The present value of this loan is:

$$\frac{\$100{,}000}{\left(1 + \left(\frac{.0282}{2}\right)\right)^{6}} = \$91{,}942$$

The excess of the loan over the present value is $8,058 or ($100,000 – $91,942). Redford Corporation is treated as if it transferred this amount to the shareholder on July 1, 2002 (the date of the loan). Frank reports this $8,058 as interest paid to Redford Corporation over the life of the loan under the OID rules.

An exception to the imputed interest rules exists for certain loans. Any day that a shareholder **demand loan** does not exceed $10,000, the imputed interest rules do not apply.

The imputed interest rules also do not apply to **term loans** if the balance **never** exceeds $10,000. However if, on any day, a term loan balance exceeds $10,000, interest begins and continues throughout the term of the loan even if the loan balance drops below $10,000.[15]

The above exceptions do not apply if the principal purpose of the loan arrangement is tax avoidance by lowering the federal tax liability of the borrower or lender through the structure of the loan.

Observation. Taxpayers who pay interest of at least the AFR avoid these calculations.

PASSIVE OR ACTIVE

A shareholder who materially participates in the corporation activity treats the non-separately stated income as active income. A shareholder who does not materially participate in the activity treats the non-separately stated income as passive. Rental income is generally passive for all shareholders, with the exception of certain real estate professionals.

Note. Information regarding real estate professionals is found in Chapter 11, Special Taxpayers.

SHAREHOLDER EXPENSES

A shareholder may have deductible expenses related to his ownership of an S corporation. Although a partner in a partnership is permitted to claim these expenses on Schedule E, this provision does **not** apply to S corporation shareholders.

For these types of expenses, the S corporation should reimburse the shareholder. This includes expenses the shareholder incurred when the S corporation was in the formation stage, such as start-up expenses.

A shareholder who personally pays expenses on behalf of the S corporation can claim a personal deduction for these expenses only as investment expenses, deductible on Schedule A as 2% miscellaneous itemized deductions. These include expenses related to employment, such as mileage, lodging, meals, etc.

If the S corporation pays the expenses, they are deductible based on the type of the expense. For example, postage expenses are ordinary business expenses, start-up expenses are capitalized and amortized, and equipment purchases are capitalized and depreciated.

15. Prop. Treas. Reg. §1.7872-9

Automobile expenses incurred by the shareholder-employee can be reimbursed by the corporation at the standard mileage rate. This gives the corporation a deduction without creating additional income for the shareholder provided the reimbursement is at or less than the standard mileage rate (37.5¢ per mile for business mileage driven in calendar year 2004).

Travel expenses incurred by a shareholder-employee can also be reimbursed. Effective October 1, 2000, meals and incidental expenses (M&IE) can be reimbursed at the per diem rate for all employees, include related parties.[16] However, the prohibition of providing a per diem for lodging for related parties still exists. Related parties can only be reimbursed based on actual costs. For this purpose, a related party is an employee owning 10% or more of the S corporation stock or a person related to a shareholder who owns 10% or more of the S corporation.

OPERATING OUT OF A SHAREHOLDER'S HOME

Expenses related to office-in-home can be deducted by the shareholder-employee on Form 2106, and carried to Schedule A as a 2% miscellaneous itemized deduction.

If the S corporation pays rent to the shareholder for the use of space, the rent is deductible by the corporation and is income to the shareholder. In most rental situations, the shareholder claims the normal expenses against this rental income. However, if the rental income is paid to rent part of the shareholder's personal residence, the shareholder is not permitted to claim expenses against this income other than mortgage interest and real estate taxes.[17]

The S corporation may be able to reimburse the shareholder-employee for expenses related to the operation of this office. Unfortunately, the Code, Regulations, rulings, and courts have not outlined what expenses are reimbursable. Logically, all extra expenses should be reimbursable. These include amounts that are above and beyond the amounts that existed prior to the existence of the office, such as additional electric, heat, and cleaning costs. Mortgage interest and real estate taxes do not change as a result of the office's existence, so they may be denied. The same may be said about depreciation of the house. It does not change as a result of the office's existence.

INTEREST PAID ON LOAN TO BUY STOCK

A taxpayer who borrows money in order to buy an interest in an S corporation can claim a deduction for the interest paid on the loan. The classification of this interest depends on whether the taxpayer purchased the interest from the S corporation or from another shareholder.[18]

If the **taxpayer purchases the S corporation stock from another shareholder,** the interest is allocated according to any reasonable method such as pro rata among the assets based on their fair market values, book values, or adjusted bases.

If the **taxpayer makes a contribution to the S corporation in exchange for stock,** the interest is allocated using any reasonable method. Reasonable methods include allocating the debt between the assets, or by tracing the debt proceeds contributed to the S corporation.

The percentage related to business operations is the percentage of the interest deductible as a business deduction. This interest should be reported on Schedule E, page 2, with the description of "business interest" followed by the name of the S corporation.

The percentage related to passive operations is the percentage of the interest treated as passive interest expense. This interest is reported on Form 8582 with the description of "passive interest" followed by the name of the S corporation.

The percentage related to investments is the percentage of the interest deductible as investment interest expense. This is reported on the investment interest expense line of Schedule A, or on Form 4952, *Investment Interest Expense Deduction* if applicable.

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16. Rev. Proc. 2000-39

17. IRC §280A(c)

18. Cumulative Bulletin Notice 88-37

DISTRIBUTIONS AND LIQUIDATION

DISTRIBUTIONS

Distributions can cause a shareholder's stock basis to go below zero. However, any amount below zero is required to be reported by the shareholder as income. These are commonly called "distributions in excess of basis" on Schedule D and reported as long-term or short-term capital gains, depending on the holding period of the stock. Because these distributions are taxable to the shareholder, they increase the basis to zero.

An S corporation is not permitted to have different distribution or liquidation rights. This is defined in the Regulations as, *"The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds."*[19] Each share has the same rights in regard to distributions and liquidation proceeds, not that each share has to necessarily receive the same distribution at the same time, but only that each share must have the same rights.

LIQUIDATION OR TERMINATION

Bad Debts

Any loan basis on unpaid loans remaining when the S corporation terminates is a bad debt deduction for the shareholder. Where the shareholder deducts this amount depends on the reasons for the loan.

Most bad debts of shareholder-S corporation loans are non-business bad debts, deducted on Schedule D as short-term capital losses. The IRS assumes the shareholders are making the loans to protect their investment in the corporation, which is an investment activity not a business activity for the shareholder.

If the loan is made as part of the shareholder's business of lending money, then the loss is deductible on the shareholder's Schedule C as a business bad debt. This is also where the shareholder reports the interest from the loan. If the shareholder is to be considered in the lending business he should be charging a banking interest rate, requiring collateral for the loan, and pursuing borrowers who have not made timely payment. Most shareholders probably do not charge a high rate of interest and probably do not demand prompt payments, nor pursue court action if necessary, therefore stating there is a banking business could be questionable.

If a loan is made in relation to the S corporation's business activities, the loan may be a business bad debt. For example, an S corporation in the construction business makes a loan to a general contractor in order to keep lucrative contracts. This is considered making the loan for business reasons.

If the loan is made as part of the shareholder's business of being an employee and there can be shown a valid business reason for the loan, then the bad debt is an employee business expense, deductible on Form 2106, which is carried to Schedule A as a 2% miscellaneous itemized deduction. This results in the entire deduction being taken in the year the debt is bad. It could create an NOL if it is large enough, although it also could trigger AMT since a taxpayer's 2% miscellaneous itemized deductions are an AMT add back.

In the *Litwin* case,[20] the taxpayer was allowed to treat the bad debt as an employee business expense. The taxpayer started his own corporation, hired himself, made lots of money and sold the corporation at a profit. He did this a second time and was again successful.

19. Treas. Reg. §1.1361-1(l)(2)

20. *Harry Litwin v. United States,* (CA-10), U.S. Court of Appeals, 10th Circuit, 91-3208, 93-1 USTC 50,041, January 9, 1993

The third time he did this, the corporation was losing money and he had to defer paying himself the large salaries he was previously paying. He sold the corporation, but continued working for the new owners, again for deferred pay. He loaned the corporation over $300,000 to keep it operating.

When the corporation collapsed, Mr. Litwin claimed a business loss for the $300,000. He took the position that he loaned the money to the corporation so it could continue operating and pay him the nice salary. He felt he could not get other jobs due to his advanced age (he was in his 50's), and he contended the $300,000 was reasonable compared to his salary (which was nearly $100,000). The Court allowed the deduction, partly based on Mr. Litwin's position and partly based on his past successes. The Court stated that Mr. Litwin's deferral of his salary did not harm his case because the corporation's minutes showed he was due the deferred salary and expected to be paid at some time in the future.

> **Practice Pointer.** When taking a position similar to the *Litwin* case, it is important to remember the "prudent business person" factor. Would a prudent business person act in the manner in question?
>
> For example, would it be prudent to lend $10,000 to an employer so it could stay in business and continue paying the lender a $100,000 per year salary?

IRC §1244 STOCK LOSSES

IRC §1244 losses are deductible if a shareholder has a loss from the disposition or liquidation of her entire interest in an S corporation. IRC §1244 treatment only applies to stock meeting the provisions. A key provision is:

- Only the **original contribution** made in exchange for the stock is eligible for the §1244 treatment.

Any additional contributions to the capital of the S corporation does not qualify for §1244 treatment unless new shares are issued in exchange for the new contributions. In addition, any additional stock basis, such as gains passed through on Schedule K-1, is not eligible for the §1244 stock treatment. The loss is required to be prorated between §1244 stock treatment and Schedule D treatment based on the investments.

Example 28. Julie invested $5,000 in Good Corporation in 2003. Her 2003 Schedule K-1 showed a $3,000 gain. This increased her basis to $8,000.

Julie's 2004 Schedule K-1 showed $0. Good Corporation liquidated and Julie received $4,000 in complete liquidation of his investment.

Julie has an $8,000 investment, of which $5,000 was an original investment that qualifies for §1244 treatment. Julie's §1244 loss is $2,500 (($5,000 ÷ $8,000) × $4,000). The remaining $1,500 of loss is a Schedule D loss.

> **Note.** Neither the Code nor other IRS guidance appear to address the allocations when the shareholder has stock basis increases from profits or contributions to capital followed by reductions due to distributions or losses. If a tax preparer takes the position that income and losses, after the original contribution, are netted and the original contribution is the remaining portion (up to the original contribution amount), he may want to advise his client in writing that the IRS could take a different position.

ENDING THE S CORPORATION

There are times when a shareholder no longer wants to operate the business as an S corporation. He then has some choices to make. The shareholder can:

1. Sell his stock to another party. This sale is reported by the shareholder on Schedule D as the sale of stock. The shareholder will receive a final Schedule K-1 for the year of the sale.
2. Change the status of the S corporation into a regular C corporation. This requires an election containing the signed approval of shareholders representing over 50% of the outstanding stock of the corporation.
3. Abandon his stock to the S corporation. This is also a deemed sale to be reported on Schedule D.
4. Liquidate the corporation.

S Corporation Stockholder Basis Carryforward Worksheet
(NO Treas. Reg. §1.1367-1(g) Election)

Name: ______________________________

	FIRST STOCK BASIS	NEXT DEBT BASIS	PTI
Beginning Of Year Basis Date: __________	________	________	________
Plus: Additional Contributions during year	________	________	N/A
Subtotal Before Current K-1	________	________	________
Plus: ALL Items of Income (Taxable & Tax-Free)			
Ordinary INCOME: trade or business	________	________	N/A
Net INCOME: rental real estate	________	________	N/A
Net INCOME: other rental activities	________	________	N/A
Interest income	________	________	N/A
Dividend income	________	________	N/A
Royalties	________	________	N/A
Net SHORT-term capital GAIN	________	________	N/A
Net LONG-term capital GAIN (Total Column)	________	________	N/A
Net IRC §1231 GAINS	________	________	N/A
Other income	________	________	N/A
Excess of S/H deduction for depletion over cost basis of property IRC §613A(c)(11)	________	N/A	N/A
Recapture of general business credits to extent recapture causes addition to asset's basis	________	________	N/A
Life insurance proceeds	________	________	N/A
Tax-exempt interest income	________	________	N/A
SUBTOTALS before Distributions	________	________	________
TOTAL DISTRIBUTIONS From K-1 $__________	(________)	N/A	(________)
SUBTOTALS for LOSS LIMITATIONS	________	________	________
Less: Nondeductible Expenses and Losses			
50% nondeductible meals & entertainment	________	________	N/A
Fines and penalties	________	________	N/A
Nondeductible club dues	________	________	N/A
Nondeductible spousal & dependent travel	________	________	N/A
Nondeductible lobbying expenses	________	________	N/A
Interest and other expenses re: tax-exempt bonds	________	________	N/A
Officer life insurance premiums	________	________	N/A
SUBTOTALS (Carry forward to page 2)	________	________	N/A

S Corporation Stockholder Basis Carryforward Worksheet
(NO Treas. Reg. §1.1367-1(g) Election)

Page 2 of 2

Name: ________________________

	FIRST STOCK BASIS	NEXT DEBT BASIS	PTI
Subtotal Balance Forward From Page 1	______	______	______
Less: Deductible Expenses and Losses			
Ordinary LOSS: trade or business	______	______	N/A
Net LOSS: rental real estate	______	______	N/A
Net LOSS: other rental activities	______	______	N/A
Net SHORT-term capital LOSS	______	______	N/A
Net LONG-term capital LOSS (Total Column)	______	______	N/A
Net §1231 LOSS	______	______	N/A
Charitable contribution	______	______	N/A
§179 expense deduction	______	______	N/A
Deductions related to portfolio income	______	______	N/A
Investment interest expense	______	______	N/A
______	______	______	N/A
______	______	______	N/A
S/H deduction for oil and gas depletion to the extent deduction is not over S/H's share of basis in property	______	______	N/A
General business credits to extent of reduction in asset's basis under §50(c)(1)	______	______	N/A
SUBTOTALS before Loan Repayments	______	______	______
LOAN REPAYMENTS			
TOTAL REPAYMENTS From K-1 $______	N/A	(______)	N/A
END OF YEAR Date:______ **TOTALS**	______	______	______

Note.

Basis cannot go below zero. Excess distribution is capital gain (ST or LT) unless C corporation has E&P.

Loan repayments > basis are capital gain if a NOTE (ST or LT). No note - excess is ordinary income.

If S/H has multiple blocks of stock or multiple loans, see regulations for special treatment and allocations.

Although cancellation of debt income excluded from taxation under IRC §108 is tax free, it is not permanently excluded from income and does not increase a shareholder's basis.[21]

[21] Treas. Reg. §1.1366-1(a)(2)(viii) and IRC §108(d)(7)(A)

S Corporation Stockholder Basis Carryforward Worksheet
(WITH Treas. Reg. §1.1367-1(g) Election)

Page 1 of 2

Name: ______________________________

	FIRST STOCK BASIS	NEXT DEBT BASIS	PTI
Beginning Of Year Basis Date: __________	______	______	______
Plus: Additional Contributions during year	______	______	N/A
Subtotal Before Current K-1	______	______	______
Plus: ALL Items of Income (Taxable & Tax-Free)			
Ordinary INCOME: trade or business	______	______	N/A
Net INCOME: rental real estate	______	______	N/A
Net INCOME: other rental activities	______	______	N/A
Interest income	______	______	N/A
Dividend income	______	______	N/A
Royalties	______	______	N/A
Net SHORT-term capital GAIN	______	______	N/A
Net LONG-term capital GAIN (Total Column)	______	______	N/A
Net IRC §1231 GAINS	______	______	N/A
Other income	______	______	N/A
Excess of S/H deduction for depletion over cost basis of property IRC §613A(c)(11)	______	N/A	N/A
Recapture of general business credits to extent recapture causes addition to asset's basis	______	______	N/A
Life insurance proceeds	______	______	N/A
Tax-exempt interest income	______	______	N/A
SUBTOTALS before Distributions	______	______	______
TOTAL DISTRIBUTIONS From K-1 $__________	(______)	N/A	(______)
SUBTOTALS for LOSS LIMITATIONS	______	______	______
Less: Deductible Expenses and Losses			
Ordinary LOSS: trade or business	______	______	N/A
Net LOSS: rental real estate	______	______	N/A
Net SHORT-term capital LOSS	______	______	N/A
Net LONG-term capital LOSS (Total Column)	______	______	N/A
Net §1231 LOSS	______	______	N/A
Charitable contribution	______	______	N/A
§179 expense deduction	______	______	N/A
Deduction related to portfolio income	______	______	N/A
Investment interest expense	______	______	N/A
______________________	______	______	N/A
S/H deduction for oil and gas depletion to extent deduction is not over S/H's share of basis in property	______	______	N/A
General business credits to extent of reduction in asset's basis under IRC §50(c)(1)	______	______	N/A
SUBTOTALS (Carry forward to page 2)	______	______	N/A

S Corporation Stockholder Basis Carryforward Worksheet
(WITH Treas. Reg. §1.1367-1(g) Election)

Page 2 of 2

Name: ______________________________

	FIRST STOCK BASIS	NEXT DEBT BASIS	PTI
Subtotal Balance Forward From Page 1	________	________	________
Less: Nondeductible Expenses and Losses			
50% nondeductible meals & entertainment	________	________	N/A
Fines and penalties	________	________	N/A
Nondeductible club dues	________	________	N/A
Nondeductible spousal & dependent travel	________	________	N/A
Nondeductible lobbying expenses	________	________	N/A
Interest and other expenses (re: tax-exempt bonds)	________	________	N/A
Officer life insurance premiums	________	________	N/A
SUBTOTALS before Loan Repayments	________	________	________
LOAN REPAYMENTS			
TOTAL REPAYMENTS From K-1 $__________	N/A	(________)	N/A
END OF YEAR Date:__________ **TOTALS**	________	________	________

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Note.

Basis cannot go below zero. Excess distribution is capital gain (ST or LT).

Loan repayments > basis are capital gain if a there is a "Note" (ST or LT). If no note, the excess is ordinary income.

If S/H has multiple blocks of stock or multiple loans, see regulations for special treatment and allocations.

Although cancellation of debt income excluded from taxation under IRC §108 is tax free, it is not permanently excluded from income and does not increase a shareholder's basis.[22]

See special rules for distributions during and after post termination transition period.

22. Treas. Reg. §1.1366-1(a)(2)(viii) and IRC §108(d)(7)(A)