

Chapter 2: S Corporation Shareholder Issues

Selected Basis Topics	A50	Net Investment Income Tax.....	A79
The Basics of Basis	A55	Corporate-Level Issues:	
Software Limitations	A66	Effects on Shareholders	A80
Alternative Minimum Tax Basis	A71	The Three Loss Limitations	A81
Shareholder Expenses	A71	Termination of Shareholder's Interest	A87

Please note. Corrections were made to this workbook through January of 2017. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

Proper tax treatment of transactions related to owning shares in an S corporation may be among the most complicated issues facing practitioners. Even professionals who have been preparing tax returns for decades may find that they still have more to learn about the various aspects of stock and loan bases.

The initial basis of a shareholder's stock in an S corporation depends on how the shareholder acquired the shares. This basis is then adjusted each year by the amount of the corporate transactions that passes through to the shareholder and by the transactions between the corporation and the shareholder.

The basis of a shareholder's loans to the corporation is generally the balance the corporation owes them adjusted for any reductions and restorations of loan basis. When determining basis in loans to the corporation, it is imperative to remember that **loans that a shareholder guarantees or cosigns are not part of a shareholder's loan basis.**

Basis is important for many reasons, including the following.

1. Distributions from the corporation may be taxable if the shareholder's basis is limited.
2. Loan repayments may be taxable if the shareholder's loan basis was previously reduced by loss deductions.
3. Pass-through losses and other deductions may be limited or suspended if the shareholder does not have enough stock or loan basis to use them in the current year.

Note. There is no IRS tax form to show the ongoing basis calculation nor is there one to show how prior-year carryforwards interact with current-year basis adjustments. However, the IRS shareholder instructions for Schedule K-1 (1120S) have worksheets that may be used for this purpose.

Transactions affected by the **at-risk rules** of IRC §465 are reported using Form 6198, *At-Risk Limitations*. The at-risk rules and passive activity rules are **additional** potential limitations on the deductibility of losses from pass-through activities.

SELECTED BASIS TOPICS

INITIAL BASIS

The **initial basis** is determined at the time the shareholder acquires stock in the S corporation. The shares may be acquired by purchase, gift, transfer from a spouse or ex-spouse, inheritance, or transfer of assets from an existing business to the corporation. A transfer of assets may be accomplished through a qualified IRC §351 exchange or may be considered a sale by the shareholder and a purchase by the corporation.

Purchased Shares

The shareholder's basis in purchased shares is the amount paid for the shares. If the purchase was from another shareholder, the basis is called the "outside basis" because records "inside" the corporation do not reflect transactions between shareholders.

Gifted Shareholder Interest

A shareholder's interest received from a donor retains the donor's basis.¹ When the donor pays gift tax, the basis is increased by a proportionate amount of the gift tax paid.²

If the donor's basis exceeds the fair market value (FMV) of the gifted share interest, the donee must track the basis for purposes of loss limitations separately from the basis for purposes of determining a capital gain or loss. For **loss limitation purposes**, the initial basis is the FMV of the shares at the time of the gift.³ For capital gain/loss on disposition, the initial basis must be adjusted based on the disposition proceeds so that:⁴

- No built-in loss is recognized, **but**
- The shareholder receives the benefit of the donor's basis in the event of a gain.

Example 1. Russell Starling owned 100 shares of Celtic Crowns Inc. (Celtic), an S corporation. At the end of 2015, his basis in the shares was \$50,000. On December 31, 2015, he gifted his shares to Thomas Addington. At that time, the shares were worth only \$10,000 due to ongoing litigation issues.

The 2016 Schedule K-1 issued to Thomas shows a loss of \$25,000 in box 1. The effect on Thomas' 2016 personal return is calculated as follows.

Stock basis for loss limitation purposes

Lesser of gifted basis or FMV at time of gift	\$10,000
Less: deductible loss ^a	(25,000)
Negative subtotal = deductible losses in excess of basis	(\$15,000)
Deductible losses carried forward to future years	15,000
Remaining stock basis for loss limitation purposes	\$ 0

^a Deductible loss limited to \$10,000.

If Thomas sells the stock on January 1, 2017 for \$40,000 or less, he has no taxable gain or loss because of the gift basis rules.

Stock basis for capital gain purposes

Gifted basis in stock	\$50,000
Less: deductible loss from 2016	(10,000)
Remaining basis in stock	\$40,000

¹ IRC §1015(a).

² IRC §1015(d)(6).

³ Treas. Reg. §1.1366-2(a)(7).

⁴ IRC §1015(a).

Note. Any loss or deduction suspended because of insufficient basis is personal to the shareholder and generally cannot be transferred to another person. If a shareholder transfers **some but not all** of their stock in the corporation, the amount of any suspended loss or deduction is not reduced, and the transferee does not acquire any portion of the disallowed loss or deduction. **If a shareholder transfers all of their stock in the corporation, any suspended loss or deduction is permanently disallowed.**⁵

Shares Transferred to a Spouse or Incident to Divorce

If a shareholder transfers stock of an S corporation to their spouse or as part of a divorce settlement, the shareholder's basis and any losses or deductions carried forward are transferred with the stock. The amount of any loss or deduction is determined by prorating any losses or deductions for the year of the transfer between the transferor and the former spouse based on the stock ownership at the beginning of the subsequent tax year.⁶

Inherited Shareholder Interest

When a shareholder dies, their shares are included in their estate at the FMV.⁷ Most estates do not file Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*,⁸ so it is often not possible to get the FMV from the executor of the estate. Therefore, it may be difficult for the beneficiary to determine the FMV of closely held corporate stock they inherited. Even the IRS stipulates that no general formula is applicable to the many situations affecting the value of such stock.⁹

One method of determining the value is to:

1. Determine the FMV of the corporate assets minus any corporate liabilities on the date of death,
2. Reduce this value by any minority or marketability discount, and
3. Multiply the resulting value by the deceased shareholder's percentage ownership of the S corporation.

Note. For a taxpayer who died in 2010, the inherited basis in the S corporation stock may be less clear. The estate's executor may have elected out of the estate-tax rules and used the modified carryover-of-basis rules. Under the special election, the executor of the decedent's estate was required to provide a statement to all heirs listing the decedent's basis in the property, the FMV of the property on the date of the decedent's death, and the additional basis allocated to the property.¹⁰

Observation. Shareholder stock may receive a stepped-up basis but the underlying property does not. For more information, see the 2016 *University of Illinois Federal Tax Workbook, Volume B*, Chapter 3: Trust and Estate Taxation.

⁵. Treas. Reg. §1.1366-2(a)(6)(i).

⁶. Treas. Reg. §1.1366-2(a)(6)(ii).

⁷. IRC §1014(a)(1).

⁸. See Joint Committee on Taxation report JCX-52-15. Mar. 16, 2015. *History, Present Law, and Analysis of the Federal Wealth Transfer Tax*.

⁹. Rev. Rul. 59-60, 1959-1 CB 237.

¹⁰. *Gifts & Inheritances*. Jan. 1, 2016. IRS. [www.irs.gov/Help-&-Resources/Tools-&-FAQs/FAQs-for-Individuals/Frequently-Asked-Tax-Questions-&-Answers/Interest,-Dividends,-Other-Types-of-Income/Gifts-&-Inheritances/Gifts-&-Inheritances] Accessed on Dec. 31, 2015.

Shares Acquired in a Qualified IRC §351 Exchange

IRC §351 governs the transfer of property to a corporation, including an S corporation. It states:

No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation.

For this nonrecognition treatment to apply, immediately after the transfer, the transferor shareholder(s) must own:

- Stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote, and
- At least 80% of the total number of shares of all other classes of stock.¹¹

Both components of this test are generally referred to as “**the 80% control test.**”

After a qualified IRC §351 exchange, the corporation “steps into the shoes” of the transferor with respect to the basis, holding period, and accumulated depreciation of assets transferred in exchange for the shares in the corporation.¹² In turn, the shareholder’s basis in their shares usually transfers from the assets to the stock received.¹³

Contributing Property with a Built-in Loss: Default Treatment. When property with a built-in loss is contributed to a corporation, the corporation’s transferred basis is limited to the property’s FMV.¹⁴ However, the **shareholder’s basis in the shares is not adjusted** for the built-in loss; the stock basis is equal to the shareholder’s basis in the assets that were transferred.¹⁵ In effect, the shareholder does not realize a tax benefit from the loss until their interest in the corporation is liquidated.

Example 2. Tara Thornbush establishes an S corporation, Toni’s Freshstarts Inc. (Toni’s) on January 1, 2016. She contributes all of her personal computer equipment and electronics to the corporation. She paid \$20,000 for the equipment over the years, but its current FMV is only \$5,000. There is a built-in loss of \$15,000 on this equipment. The corporation’s basis in the transferred assets is \$5,000. Tara’s basis in her shares is \$20,000.

Tara’s shares are worth \$5,000 (the value of the equipment transferred into Toni’s). If she sold her shares immediately, she would recognize a \$15,000 loss. This is the same result that would occur if she sold the equipment directly to someone else. Therefore, the loss is preserved in her shares but not in the corporation.

Note. For more information about S corporations and §351 exchanges, see the 2012 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: S Corporations. This can be found at www.taxschool.illinois.edu/taxbookarchive.

Contributing Property with a Built-in Loss: Alternate Treatment. If both the shareholder and the corporation make a joint election under IRC §362(e)(2)(C), the S corporation’s basis in built-in loss property that is contributed to the corporation retains the shareholder’s basis in the property, which is greater than the FMV of the property. However, the shareholder’s basis in the S corporation stock is reduced to the **FMV of the property** (instead of the shareholder’s basis in the contributed property, which exceeds FMV).

¹¹. IRC §368(c).

¹². IRC §362(a).

¹³. IRC §358(a).

¹⁴. IRC §362(e)(2).

¹⁵. IRC §358(a).

This election is irrevocable once made. To make the election, the shareholder and the corporation must enter into a written, binding agreement to elect to apply IRC §362(e)(2)(C) to the transfer. In addition, a statement must be filed with the IRS indicating that the agreement is in place and the election is being made. Generally, the shareholder is required to file the statement with their timely filed (including extensions) original federal return for the tax year in which the transfer occurs.¹⁶ If the shareholder is not required to file a federal return, the procedures in Treas. Reg. §1.362-4(d) should be followed.

The election statement is titled “Section 362(e)(2)(C) Statement.” It must:¹⁷

1. Identify (by name and tax identification number, if any) the shareholder and the S corporation;
2. State that the transferring shareholder and the acquiring corporation have entered into a written, binding agreement to elect to apply IRC §362(e)(2)(C) as required under Treas. Reg. §1.362-4(d)(1)(i); and
3. State the date(s) of the transaction(s) to which the election applies.

Observations. If the built-in loss property is depreciable, the shareholder(s) may realize a tax benefit from the property, as it is incrementally included in depreciation expense each year.

If the corporation sells the property, any loss passes through to the shareholder(s). However, the shareholder(s) must have sufficient basis in the corporation to deduct the loss.

If the contributing shareholder still owns their shares at the time the equipment is sold or otherwise disposed of and they have sufficient basis in the corporation, they may be able to realize a tax benefit from the disposition of the property sooner than they would from the disposition of their shares in the corporation.

If there are multiple shareholders and they qualify as a group under the IRC §351 rules, use of this election causes the loss to be shared among the stockholders in proportion to their ownership in the corporation.

Shares Acquired in a Nonqualified Exchange for Property

If a taxpayer receives stock in an S corporation in exchange for property transferred to the corporation but does not meet the control tests of IRC §351, they must recognize a gain or loss on the disposition of the property exchanged.¹⁸ The sales price of the assets is the value of the shares received, and the shareholder’s initial basis in the shares received is the FMV of the shares at the time of the exchange.¹⁹ However, these general rules are modified if the stockholder owns more than 50% of the corporation’s stock, directly or indirectly, after the exchange. See IRS Pub. 544, *Sales and Other Dispositions of Assets*, for more information.

IRC §179 DEDUCTION

The IRC §179 deduction is a separately stated item on Schedule K-1. It is grouped with other separately stated deductions and reduces the basis accordingly in the year incurred. (Absent the special ordering election, these are Tier 4 deductions. See “Ordering Rules” later in this chapter.) Even if the shareholder does not qualify to claim the §179 deduction due to other restrictions, the basis reduction is still effective in the year that the §179 deduction passes through to the shareholder.²⁰

¹⁶ IRS Notice 2005-70, 2005-41 IRB 694.

¹⁷ Treas. Reg. §1.362-4(d)(3).

¹⁸ IRC §1001(c).

¹⁹ IRS Pub. 542, *Corporations*.

²⁰ Treas. Reg. §1.179-1(f)(2).

Example 3. Nancy Flannigan has investments in a number of ventures, including a **25% interest in Delegated Authority Inc. (Delegated), an S corporation,** and a **100% interest in American Leagues LLC (American).** For the 2015 tax year, Delegated passed through a §179 deduction of \$10,000. Nancy's basis in her Delegated stock was sufficient to absorb this deduction and was decreased accordingly.

However, after combining her **losses in American** with her income from Delegated, Nancy had a **net loss** of \$20,000 from her business ventures in which she actively participated in 2015. Her overall §179 deduction for 2015 was therefore disallowed. The \$10,000 deduction from Delegated will be carried forward until she has sufficient business profits to absorb the expense.

A shareholder who has not been able to take the §179 deduction that previously flowed through from an S corporation may increase their basis in the corporation by the amount previously not deducted when either the asset is sold by the corporation or the shareholder disposes of their stock in the S corporation.²¹

Example 4. Use the same facts as **Example 3.** Nancy's basis in her Delegated (S corporation) stock at the beginning of 2015 was \$160,000. She increased her basis by the ordinary income of \$25,000 reported on line 1 of her Schedule K-1 and reduced her basis by the \$10,000 IRC §179 deduction. Her basis at the end of 2015 was \$175,000 ($\$160,000 + \$25,000 - \$10,000$).

Nancy sold her Delegated shares in 2016 for \$200,000. She did not receive any distributions from Delegated in 2016. Her 2016 Schedule K-1 shows ordinary income of \$7,000. Her basis before any adjustments is \$182,000 ($\$175,000 + \$7,000$). When Nancy prepares her 2016 return, the \$10,000 §179 deduction that carried forward from 2015 is still disallowed due to the business income limitations.

Before calculating her gain on the sale of her Delegated stock, Nancy adds the \$10,000 disallowed §179 deduction to her basis. Her adjusted basis is \$192,000 ($\$182,000 + \$10,000$). Her 2016 capital gain from the sale of her interest in Delegated is \$8,000 ($\$200,000$ sales price – \$192,000 basis).

Nancy must also reduce the amount of §179 expense that she carries forward to 2017 by the \$10,000 that she used to increase her basis in the stock she sold.

CHARITABLE CONTRIBUTIONS OF APPRECIATED PROPERTY

A taxpayer is allowed to claim a charitable deduction for the FMV of certain appreciated property donated to a qualified organization. A donation by an S corporation is deducted as a charitable contribution on the shareholder's Schedule A. Even though the shareholder is allowed to deduct the FMV of the **donation**, the basis in their S corporation stock is reduced only by their pro-rata share of the corporation's basis in the **property**.²²

TAX CREDITS

A tax credit that passes through to a shareholder of an S corporation does not directly affect the shareholder's basis.²³ To the extent that the credit affects the basis of property or deductions, the effect does pass through, but the credit itself is not taken into account when determining basis.

Example 5. Jackson Hugget owns 100% of Maltese Eagle Eye Inc. (Maltese), an S corporation that provides private detective services. In 2015, Maltese incurred \$30,000 in expenses to provide its employees with health insurance. The corporation qualified for a small employer health insurance premium tax credit²⁴ of \$10,000. On its Form 1120S, *U.S. Income Tax Return for an S Corporation*, the corporation claimed the net expense of \$20,000.

The corporation's pass-through ordinary loss for 2015 was \$15,000. At the beginning of the year, Jackson's stock and loan basis were both zero. Although Jackson cannot claim the loss on his 2015 individual return, he can claim the pass-through credit of \$10,000. His basis is not affected by claiming the credit.

²¹ Treas. Reg. §1.179-3.

²² IRC §§1366(d)(4) and 1367(a)(2).

²³ IRC §§1367 and 1368.

²⁴ See IRC §45R.

THE BASICS OF BASIS²⁵

2

STOCK BASIS

A shareholder's S corporation stock basis is generally calculated at the end of the corporation's tax year. Each shareholder is responsible for keeping the information needed to calculate the basis of their stock in the corporation. Schedule K-1 provides information to help shareholders determine their stock basis at the end of each corporate tax year.

Note. Although shareholders are responsible for maintaining the information needed to calculate their bases, shareholders often do not understand how to do this. Ideally, the S corporation's return preparer will provide any additional information they have that will aid the shareholder's return preparer to accurately determine shareholders' bases.

Distributions of Property

From a shareholder's perspective, there is no difference between distributions of property and distributions of cash. The property's FMV is used for purposes of determining the tax consequences to the shareholder.

Note. For the effect of the distribution at the corporate level, see the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: S Corporation Entity Issues.

Loss Limitations

As an initial rule, a shareholder's current loss deduction is limited to their stock basis plus their basis in any debt owed by the corporation to that shareholder.²⁶ Any excess loss that is not deductible is carried forward and can be claimed by the shareholder when sufficient basis is present.

Nondeductible expenses are considered independently from deductible losses and other separately stated deductions when determining the amounts allowed under the basis limitation rules. Amounts carried forward from previous years are grouped with current-year items when calculating the amount of losses allowed in the current year.

Ordering Rules

The Code establishes the order in which the transactions are considered in determining the shareholder's basis in both stock and loans. The Code also allows the shareholder to elect to do this calculation in a slightly different order. The default order follows.

- Tier 1.** Basis is **increased** by all capital contributions made to the corporation and all income (including tax-exempt income) reported on Schedule K-1.
- Tier 2.** Basis is **decreased** by property distributions (including cash) made by the corporation. (This does not include dividend distributions reported on Form 1099-DIV, *Dividends and Distributions*.)
- Tier 3.** Basis is **decreased** by nondeductible expenses (i.e., 50% of meals and entertainment expenses).
- Tier 4.** Basis is **decreased** by all deductible losses and expenses that are individually stated on Schedule K-1 (i.e., charitable contributions and IRC §179 expenses). **Throughout the following examples and calculations, this is referred to as deductible losses.**

Note. This list is intended to provide a general review. Certain transactions must be treated in specific ways, and they are discussed in more detail later in the chapter.

²⁵ Shareholder's Instructions for Schedule K-1 (Form 1120S).

²⁶ Treas. Reg. §1.1366-2(a).

2016 Workbook

Example 6. Erik Northernman started a nightclub that he incorporated as Midnight Sun Inc. in 2014. He made an S election effective as of the day of incorporation. He paid \$1,000 for his shares and did not personally loan any money to the company. He received the following Schedule K-1 from the corporation for 2014.

671113

Schedule K-1
(Form 1120S)
Department of the Treasury
Internal Revenue Service

2014

For calendar year 2014, or tax
year beginning Apr. 1, 2014
ending Dec. 31, 20 **14**

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	37-9999999
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B Corporation's name, address, city, state, and ZIP code

Midnight Sun, Inc.
2913 E. Anaheim St.
Shreveport, LA 71109

C IRS Center where corporation filed return
Ogden, UT 84201-0013

Part II Information About the Shareholder

D Shareholder's identifying number **371-11-1111**

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

Erik Northernman
2913 E. Anaheim St.
Shreveport, LA 71109

F	Shareholder's percentage of stock ownership for tax year	100.00 %
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☐ Final K-1
 ☐ Amended K-1
 OMB No. 1545-0047

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

1	Ordinary business income (loss)	13	Credits
	30,000		
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
		A	3,000
12	Other deductions		
A	800	C	500
		D	15,000
		17	Other information

* See attached statement for additional information.

For Paperwork Reduction Act Notice, see Instructions for Form 1120S.

IRS.gov/form1120s

Cat. No. 11520D

Schedule K-1 (Form 1120S) 2014

For Example 6

Schedule K-1 (Form 1120S) 2014

Page **2**

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

	Code	Report on
1. Ordinary business income (loss). Determine whether the income (loss) is passive or nonpassive and enter on your return as follows:		
Passive loss	Report on	
Passive income	See the Shareholder's Instructions	
Nonpassive loss	Schedule E, line 28, column (g)	
Nonpassive income	Schedule E, line 28, column (h)	
2. Net rental real estate income (loss)	Schedule E, line 28, column (j)	
3. Other net rental income (loss)	See the Shareholder's Instructions	
Net income		
Net loss	Schedule E, line 28, column (g)	
4. Interest income	See the Shareholder's Instructions	
5a. Ordinary dividends	Form 1040, line 8a	
5b. Qualified dividends	Form 1040, line 9a	
6. Royalties	Form 1040, line 9b	
7. Net short-term capital gain (loss)	Schedule E, line 4	
8a. Net long-term capital gain (loss)	Schedule D, line 5	
8b. Collectibles (28%) gain (loss)	Schedule D, line 12	
	28% Rate Gain Worksheet, line 4 (Schedule D instructions)	
8c. Unrecaptured section 1250 gain	See the Shareholder's Instructions	
9. Net section 1231 gain (loss)	See the Shareholder's Instructions	
10. Other income (loss)		
Code		
A Other portfolio income (loss)	See the Shareholder's Instructions	
B Involuntary conversions	See the Shareholder's Instructions	
C Sec. 1256 contracts & straddles	Form 6781, line 1	
D Mining exploration costs recapture	See Pub. 535	
E Other income (loss)	See the Shareholder's Instructions	
11. Section 179 deduction	See the Shareholder's Instructions	
12. Other deductions		
A Cash contributions (50%)	See the Shareholder's Instructions	
B Cash contributions (30%)		
C Noncash contributions (50%)		
D Noncash contributions (30%)		
E Capital gain property to a 50% organization (30%)		
F Capital gain property (20%)		
G Contributions (100%)		
H Investment interest expense	Form 4952, line 1	
I Deductions—royalty income	Schedule E, line 19	
J Section 59(e)(2) expenditures	See the Shareholder's Instructions	
K Deductions—portfolio (2% floor)	Schedule A, line 23	
L Deductions—portfolio (other)	Schedule A, line 28	
M Preproductive period expenses	See the Shareholder's Instructions	
N Commercial revitalization deduction from rental real estate activities	See Form 8582 instructions	
O Reforestation expense deduction	See the Shareholder's Instructions	
P Domestic production activities information	See Form 8903 instructions	
Q Qualified production activities income	Form 8903, line 7b	
R Employer's Form W-2 wages	Form 8903, line 17	
S Other deductions	See the Shareholder's Instructions	
13. Credits		
A Low-income housing credit (section 42(j)(5)) from pre-2008 buildings	See the Shareholder's Instructions	
B Low-income housing credit (other) from pre-2008 buildings		
C Low-income housing credit (section 42(j)(5)) from post-2007 buildings		
D Low-income housing credit (other) from post-2007 buildings		
E Qualified rehabilitation expenditures (rental real estate)		
F Other rental real estate credits		
G Other rental credits		
H Undistributed capital gains credit	Form 1040, line 73, box a	
I Biofuel producer credit	See the Shareholder's Instructions	
J Work opportunity credit		
K Disabled access credit		
L Empowerment zone employment credit		
M Credit for increasing research activities		
14. Foreign transactions		
A Name of country or U.S. possession	See the Shareholder's Instructions	
B Gross income from all sources		
C Gross income sourced at shareholder level		Form 1116, Part I
<i>Foreign gross income sourced at corporate level</i>		
D Passive category	Form 1116, Part I	
E General category		
F Other		
<i>Deductions allocated and apportioned at shareholder level</i>		
G Interest expense	Form 1116, Part I	
H Other	Form 1116, Part I	
<i>Deductions allocated and apportioned at corporate level to foreign source income</i>		
I Passive category	Form 1116, Part I	
J General category		
K Other		
<i>Other information</i>		
L Total foreign taxes paid	Form 1116, Part II	
M Total foreign taxes accrued	Form 1116, Part II	
N Reduction in taxes available for credit	Form 1116, line 12	
O Foreign trading gross receipts	Form 8873	
P Extraterritorial income exclusion	Form 8873	
Q Other foreign transactions	See the Shareholder's Instructions	
15. Alternative minimum tax (AMT) items		
A Post-1986 depreciation adjustment	See the Shareholder's Instructions and the Instructions for Form 6251	
B Adjusted gain or loss		
C Depletion (other than oil & gas)		
D Oil, gas, & geothermal—gross income		
E Oil, gas, & geothermal—deductions		
F Other AMT items		
16. Items affecting shareholder basis		
A Tax-exempt interest income	Form 1040, line 8b	
B Other tax-exempt income	See the Shareholder's Instructions	
C Nondeductible expenses		
D Distributions		
E Repayment of loans from shareholders		
17. Other information		
A Investment income	Form 4952, line 4a	
B Investment expenses	Form 4952, line 5	
C Qualified rehabilitation expenditures (other than rental real estate)	See the Shareholder's Instructions	
D Basis of energy property	See the Shareholder's Instructions	
E Recapture of low-income housing credit (section 42(j)(5))	Form 8611, line 8	
F Recapture of low-income housing credit (other)	Form 8611, line 8	
G Recapture of investment credit	See Form 4255	
H Recapture of other credits	See the Shareholder's Instructions	
I Look-back interest—completed long-term contracts	See Form 8697	
J Look-back interest—income forecast method	See Form 8866	
K Dispositions of property with section 179 deductions	See the Shareholder's Instructions	
L Recapture of section 179 deduction		
M Section 453(j)(3) information		
N Section 453A(c) information		
O Section 1260(b) information		
P Interest allocable to production expenditures		
Q CCF nonqualified withdrawals		
R Depletion information—oil and gas		
S Reserved		
T Section 108(i) information		
U Net investment income		
V Other information		

2016 Workbook

Erik's yearend basis in the corporation is calculated as follows.

	Stock purchase		\$ 1,000
Tier 1	Plus: items of income		
	Ordinary income (box 1)	30,000	
	Tax-exempt income (box 16, code A)	3,000	
	Total Items of Income	<u>\$33,000</u>	<u>33,000</u>
	Remaining basis (stock purchase plus total items of income)		\$34,000
Tier 2	Less: distributions (box 16, code D)		<u>(15,000)</u>
	Remaining basis		\$19,000
Tier 3	Less: nondeductible losses (box 16, code C)		<u>(500)</u>
	Remaining basis		\$18,500
Tier 4	Less: deductible losses (box 12, code A)		<u>(800)</u>
	Remaining basis at the end of 2014		\$17,700

Optional Ordering Election

Every shareholder has the option **to elect** to decrease basis first by deductible losses and then by nondeductible expenses. This election applies to both stock basis and loan basis.

Note. At first glance, making this election seems to be an easy decision. However, when at-risk rules limit a shareholder to the amount of current deductions for losses, they have to decide if it is better to carry over nondeductible expenses or deductible expenses to the next year. If the shareholder expects their future income to be higher, carrying over the deductible expenses may produce better tax results, and the election should not be made.

If the taxpayer's basis is limited, making this election may allow them to claim deductions earlier than they could without making the election. Once made, the election is **irrevocable** except with IRS consent. To make the election, the taxpayer must attach a statement to their timely filed original or amended return that:

1. Identifies the corporation,
2. States that the taxpayer is making the special ordering election under Treas. Reg. §1.1367-1(g), and
3. Agrees to the carryover rules under the regulation.

Example 7. Use the same facts as **Example 6**. For **2015**, Erik received a Schedule K-1 from Midnight Sun Inc. with the following information.

Ordinary income (box 1)	\$50,000
Distributions (box 16, code D)	65,700
Nondeductible expenses (box 16, code C)	5,000
Deductible losses (box 12, code A)	6,000

Erik's 2015 basis is calculated as follows.

	Carryforward basis from 2014	\$17,700
Tier 1	Plus: items of income — Ordinary income (box 1)	<u>50,000^a</u>
	Remaining basis (carryforward basis plus total items of income)	\$67,700
Tier 2	Less: distributions (box 16, code D)	<u>(65,700)^b</u>
	Remaining basis	\$ 2,000
Tier 3	Less: nondeductible losses (box 16, code C)	<u>(5,000)</u>
	Negative subtotal = nondeductible expenses in excess of basis	(3,000) ^c
	Nondeductible expenses do not carry forward to future years	<u>3,000</u>
	Remaining basis	\$ 0
Tier 4	Less: deductible losses (box 12, code A)	<u>(6,000)</u>
	Negative subtotal = deductible losses in excess of basis	(6,000)
	Deductible losses carried forward to future years	<u>6,000</u>
	Remaining basis at the end of 2015	\$ 0

^a Taxable income.

^b All distributions absorbed by basis.

^c \$2,000 nondeductible expenses absorbed.

Erik included the \$50,000 in income on his 2015 return, but he was not allowed to claim any of the deductible losses that year. He carries these expenses forward until he has sufficient basis to deduct them **after** taking into account nondeductible expenses for the current year. This is required unless he makes the Treas. Reg. §1.1367-1(g) election.

Example 8. Use the same facts as **Example 7**, except Erik makes the election under Treas. Reg. §1.1367-1(g) to reduce basis by deductible losses before nondeductible expenses. This changes his calculation of basis to the following.

	Remaining basis after Tier 2 adjustments	\$2,000 ^a
Optional Tier 3	Less: deductible losses (box 12, code A)	<u>(6,000)</u>
	Negative subtotal = deductible losses in excess of basis	(\$4,000)
	Deductible losses carried forward to future years	<u>4,000^b</u>
	Remaining basis	\$ 0
Optional Tier 4	Less: nondeductible expenses (box 16, code C)	<u>(5,000)</u>
	Negative subtotal = nondeductible expenses in excess of basis	(5,000)
	Nondeductible expenses carried forward to future years	<u>5,000</u>
	Remaining basis at the end of 2015	\$ 0

^a See **Example 7**.

^b \$2,000 deduction on 1040.

Erik included the \$50,000 in income on his 2015 return. He claimed \$2,000 of the deductible losses and carried forward the remaining \$4,000. He carries these expenses forward until he has sufficient basis to deduct them. He also carries forward the \$5,000 of nondeductible expenses.

Note. Not all tax software has the option to indicate that the Treas. Reg. §1.1367-1(g) election was made. When the taxpayer has insufficient basis, it may be necessary to **manually** adjust the data input of the Schedule K-1.

Distributions in Excess of Stock Basis

Distributions in excess of stock basis are taxable to the shareholder who receives them. Excess distributions are taxed as capital gains.²⁷ If the shareholder owned the stock for more than one year, the gain is taxed as a **long-term** capital gain. Distributions in excess of basis are reported on Form 8949, *Sales and Other Dispositions of Capital Assets*.

Example 9. Use the same facts as **Example 6**, except that Erik received \$35,000 in distributions in 2014.

	Stock purchase		\$ 1,000
Tier 1	Plus: items of income:		
	Ordinary income (box 1)	\$30,000 ^a	
	Tax-exempt income (box 16, code A)	3,000 ^b	
	Total income items	<u>\$33,000</u>	<u>33,000</u>
	Remaining basis (stock purchase plus total items of income)		\$34,000
Tier 2	Less: distributions (box 16, code D)		<u>(35,000)</u>
	Negative subtotal = distributions in excess of basis		(1,000)
	Taxable distributions in excess of basis		<u>1,000^a</u>
	Remaining basis		\$ 0

^a Taxable, reported on 1040.

^b Tax exempt, reported on 1040.

Because Erik purchased the stock in 2014, his distributions are taxed as **short-term** capital gains. The distributions in excess of basis are reported on Form 8949, on which box C (“short-term transactions not reported on Form 1099-B”) is checked.

Note. In **Example 9**, the nondeductible expenses and the deductible losses (shown in **Example 6**) do not affect basis until future additions create a basis above zero. The deductible losses that were not allowed are carried forward indefinitely. These issues are discussed in more detail later in the chapter.

Nontaxable Debt Forgiveness

Qualified debt forgiveness is excluded from income under IRC §108. The tests for exclusion from gross income of discharge of indebtedness are applied at the corporate level for an S corporation.²⁸ A shareholder cannot increase their stock basis by income excluded under this provision.²⁹

LOAN BASIS

Loans that the stockholder makes to the corporation establish the initial loan basis. Repayments of these loans reduce the loan basis. If the corporation has losses in excess of the stock basis, the shareholder reduces any remaining loan basis by the amount of those losses.

Once the loan basis has been reduced, future income restores the basis up to the amount of the outstanding loan at the beginning of the tax year. Loan basis **must** be restored before any net increase is applied to restore the basis of a shareholder’s stock in an S corporation.³⁰

²⁷ IRC §1368(b)(2).

²⁸ IRC §108(d)(7)(A).

²⁹ IRC §108(d)(7)(C).

³⁰ IRC §1367(b)(2)(B).

Example 10. Chip Tollhouse started an S corporation in 2015 named Heartstone Ltd. He invested \$10,000 in the stock and loaned the company \$20,000. His 2015 Schedule K-1 showed an ordinary loss of \$15,000 in box 1 and nondeductible expenses of \$1,500 in box 16 (code C). Chip did not take any distributions or loan repayments in 2015. His stock and loan bases at the end of 2015 are calculated as follows.

Stock Basis

	Stock purchase	\$10,000
Tier 1	Plus: income and additional capital contributions	0
Tier 2	Less: distributions	(0)
Tier 3	Less: nondeductible expenses	(1,500)
	Subtotal	\$ 8,500
Tier 4	Less: deductible losses	(15,000) ^a
	Negative subtotal = deductible losses in excess of basis	(\$ 6,500)
	Deductible losses carried to debt basis calculation	6,500 ^b
	Remaining stock basis	\$ 0

Loan Basis

	Initial loan basis	\$ 0
	Current year loans to corporation	20,000
	Less: loan repayments	(0)
Tier 3	Less: nondeductible expenses in excess of stock basis	(0)
Tier 4	Less: deductible losses in excess of stock basis	(6,500) ^c
	Remaining loan basis	\$13,500

^a \$8,500 deducted on 1040.

^b Not carried forward because he has debt basis.

^c \$6,500 deducted on 1040.

Example 11. Use the same facts as **Example 10**. For 2016, Chip's Schedule K-1 from Heartstone Ltd. shows ordinary income of \$50,000 in box 1 and no other reportable transactions. Chip's loan basis is first restored by the \$6,500 loss he deducted in 2015 against his loan basis. The remaining \$43,500 of the 2016 ordinary income is added to his stock basis.

After the loan basis is applied against losses, future repayments of these loans may create taxable income for the shareholder-lender if the loan basis was not restored. This income may be treated as ordinary income, or it may be treated as capital gain depending on the structure of the loan agreement, if any. (See "Repayments of Reduced-Basis Loans" later in this section.)

Debt That Does Not Increase Basis

Only bona fide debt due to a shareholder establishes basis for that shareholder. In most cases, the determination of whether a debt is bona fide is made under general federal tax principles and depends on all the facts and circumstances.³¹ In general, the shareholder does not gain basis from money the S corporation borrows from non-shareholder creditors.

Furthermore, a shareholder does **not** obtain debt basis in an S corporation merely by guaranteeing a loan or acting as a surety or accommodation party or in any similar capacity relating to a loan.³² However, if a shareholder makes a payment on behalf of the S corporation on a loan in which they are a guarantor, then they may increase their debt basis to the extent of that payment.

³¹ Treas. Reg. §1.1366-2(a)(2)(i).

³² Treas. Reg. §1.1366-2(a)(2)(ii).

Example 12. Pam Sanford is the sole shareholder in the S corporation De Beaufort Service Inc. (De Beaufort). In 2015, she loaned the corporation \$10,000, as evidenced by a note payable from the company. De Beaufort also obtained a \$50,000 loan from Herget Bank to expand its operations. Pam was required by the bank to guarantee the loan. De Beaufort had no other outstanding loans in 2015.

At the beginning of the year, Pam's stock basis was \$0. De Beaufort reported a \$30,000 loss on Pam's Schedule K-1.

Pam was allowed to deduct \$10,000 of the 2015 loss on her personal return, which reduced the basis in her note payable to De Beaufort to zero. The remaining \$20,000 loss was carried forward to 2016.

Example 13. Use the same facts as **Example 12**. In 2016, the bank requires Pam to personally pay \$5,000 on the bank loan to keep it from going into default. This payment can be treated as a loan from Pam to De Beaufort and increase her debt basis, or it can be treated as a capital infusion and increase her stock basis.

Documented Versus Undocumented Loans

Ideally, shareholders adequately document all the loans they make to an S corporation and all subsequent repayments on these loans. In practice, however, many shareholders make numerous advances to an S corporation without formally documenting any of the advances as loans. They also take repayments of the advances without indicating which particular loans are being repaid.

Loans made in this manner are called **open-account debt**.³³ If the balance of these loans at the end of the corporation's tax year is less than \$25,000, they are treated as a single loan. This special rule makes determining the tax consequences of advances and repayments much simpler. However, loan repayments on reduced-basis open-account debt create **ordinary income** for the shareholder.³⁴ In contrast, loan repayments on reduced-basis loans that are properly documented create **capital gain** income.³⁵

If the balance of the open-account debt exceeds \$25,000 **at the end of the year**, the debt must be separated into its components and activity must be tracked separately for each loan.³⁶

Repayments of Reduced-Basis Loans

As explained previously, loans made by a shareholder to an S corporation can be used as the basis for claiming losses and other pass-through deductions. When those loans are repaid and the basis has not been restored, all or part of the repayments are taxable. The taxable portion of a partial repayment is calculated based on the pro-rata value of the basis at the beginning of the tax year versus the total loan.³⁷

Example 14. Bill Compton is the 100% shareholder in Compton Antiques Inc. (Compton), an S corporation. At the beginning of 2015, he had no basis in his stock and the corporation owed him \$22,500 in open-account debt. The remaining **basis of the debt was \$7,500** at the beginning of the year.

During 2015, Compton repaid \$15,000 of the loan after an upturn in business. Unfortunately, the repayment was premature and the company subsequently borrowed a significant amount of money from the bank to cover operating losses incurred later in the year. Bill did not make any additional contributions of capital nor did he make any additional loans to the company in 2015.

³³ Treas. Reg. §1.1367-2(a)(2).

³⁴ Rev. Rul. 68-537, 1968-2 CB 372.

³⁵ Rev. Rul. 64-162, 1964-1 CB 304.

³⁶ Treas. Reg. §1.1367-2(a)(2)(ii).

³⁷ Treas. Reg. §1.1367-2(e), Example 7; See also *Smith v. Comm'r*, 424 F.2d 219 (9th Cir. 1970), *aff'd* 48 TC 872 (1967).

Bill's 2015 Schedule K-1 from Compton showed ordinary losses of \$3,000. The following calculation shows the tax effect of these circumstances.

Basis at the beginning of 2015	\$ 7,500	
Loan balance at the beginning of 2015	÷ 22,500	
Proportion of basis to loan balance	33.33%	
Loan repayments in 2015	× 15,000	\$15,000
Nontaxable portion of loan repayments	\$5,000	(5,000)
Taxable portion of loan repayments		\$10,000

The \$10,000 was included in income on Bill's 2015 return. Because the loans were open-account debt, the \$10,000 was taxed as ordinary income.

Bill's adjusted basis in the loan after the repayments was \$2,500 (\$7,500 beginning basis – \$5,000 nontaxable payments.) Of the \$3,000 loss passed through from Compton, \$2,500 was deducted on Bill's 2015 return and the remaining \$500 was carried forward to 2016.

Restoration of Reduced-Basis Debt

The reduction in the debt basis up to the balance of the debt at the beginning of the tax year is restored first, before any net increase is applied to restore the basis of a shareholder's stock in an S corporation.³⁸ Increases to the debt basis are taken into account before calculating the taxable portion of any loan repayments.³⁹

Example 15. Use the same facts as **Example 14**, except Bill's 2015 Schedule K-1 showed **ordinary income** of \$3,000. The following calculation shows the tax effect of these circumstances.

Basis at the beginning of 2015	\$ 7,500	
Plus: increases in basis from 2015 K-1	3,000	
Adjusted loan basis	\$10,500	
Loan balance at the beginning of 2015	÷ 22,500	
Proportion of basis to loan balance	46.67%	
Loan repayments in 2015	× 15,000	\$15,000
Nontaxable portion of loan repayments	\$ 7,000	(7,000)
Taxable portion of loan repayments		\$ 8,000

The \$8,000 was taxed as ordinary income on Bill's 2015 return. Bill's adjusted loan basis after the repayments was \$3,500 (\$10,500 adjusted basis – \$7,000 nontaxable payments.) The \$3,000 in ordinary income reported on the Schedule K-1 was also included in Bill's 2015 income.

Note. If the debt in **Example 14** and **Example 15** was **not** open-account debt and instead had been properly documented and formalized, the gains on the repayment would have been taxed as capital gains.

³⁸ IRC §1367(b)(2)(B).

³⁹ Treas. Reg. §1.1367-2(d)(1).

2016 Workbook

Multiple Loans

A shareholder may make more than one formal documented loan to an S corporation. In addition, if the balance of open-account debt exceeds \$25,000 at the end of any year, the open-account debt must be tracked as separate loans for all subsequent years. In this case, the losses reduce the debt basis in proportion to the shareholder's **basis** in each debt.⁴⁰

Example 16. Mariana Maynard is sole shareholder of Bacchus Entertainments Inc. (Bacchus), an S corporation. In 2014, she loaned the corporation \$20,000. At the beginning of 2014, she had a stock basis of \$7,000. The 2014 operating loss was \$12,000. This loss was applied against Mariana's existing stock and debt bases as follows. (Tiers with \$0 entries and the resulting subtotals are not shown.)

Stock Basis

	Beginning basis	\$ 7,000
Tier 4	Less: deductible losses	(12,000) ^a
	Negative subtotal = deductible losses in excess of basis	(\$ 5,000)
	Deductible losses carried to debt basis calculation	5,000 ^b
	Remaining stock basis as of 12/31/2014	\$ 0

Loan Basis

	Initial loan basis	\$ 0
	Current year loans to corporation	20,000
Tier 4	Less: deductible losses in excess of stock basis	(5,000) ^c
	Remaining loan basis as of 12/31/2014	\$15,000

^a \$7,000 deducted on 1040.

^b Not carried forward because she has debt basis.

^c \$5,000 deducted on 1040.

In 2015, Mariana loaned Bacchus an additional \$10,000. The corporation had a 2015 operating loss of \$8,000. Mariana's basis adjustments to the two loans are as follows.

	2014 Loan	2015 Loan	Total
2015 beginning basis and new loans	\$15,000	\$10,000	\$25,000
2015 loss	\$8,000	\$8,000	\$8,000
Percent of total debt basis	× 60%	× 40%	× 100%
Loss apportioned	\$4,800 (4,800)	\$3,200 (3,200)	\$8,000 (8,000)
Basis after 2015 loss	\$10,200	\$ 6,800	\$17,000

Restoration applies first to loans repaid during the year to prevent the shareholder from recognizing gain. If multiple debts exist, remaining income amounts are then applied to each debt in proportion to the amount that **each debt was reduced in prior years** relative to the total amount of overall reduction for all the debts.⁴¹

⁴⁰ Treas. Reg. §§1.1367-2(d)(2)(ii) and (e), Example 1.

⁴¹ Treas. Reg. §1.1367-2(c)(2).

Example 17. Use the same facts as **Example 16**. For 2016, Bacchus has operating net income of \$12,000. The 2014 and 2015 loans still exist. The operating income provides Mariana with basis, and her debt basis is restored before any stock basis. The basis in the two loans is restored in proportion to the total prior reductions. The calculations follow.

	2014 Loan	2015 Loan	Total
2014 reductions to basis	\$ 5,000		\$ 5,000
Plus: 2015 reductions to basis	4,800	3,200	8,000
Pre-2016 reductions to basis	\$ 9,800	\$ 3,200	\$13,000
Divided by total pre-2016 reductions to basis	÷ 13,000	÷ 13,000	÷ 13,000
Percent of total reductions applied to each debt	75.385%	24.615%	100%
Amount of 2016 basis (income) to allocate	× 12,000	× 12,000	× 12,000
Amount of 2016 basis applied to each debt	\$ 9,046	\$ 2,954	\$12,000
Plus: basis after 2015 loss	10,200	6,800	17,000
Basis after 2016 income	\$19,246	\$ 9,754	\$29,000

Contributions to Capital

Contributions to capital are not income.⁴² Therefore, such contributions increase the stock basis but not the debt basis.

Example 18. Terrance Belleflour was the 100% shareholder in Forts4U Inc. (Forts4U), an S corporation. At the end of 2014, the corporation owed him \$50,000. **Terrance's basis in the loan was \$0.**

In **January** 2015, Forts4U obtained a line of credit from a local bank. Terrance guaranteed the debt. The corporation used part of the funds borrowed on the line of credit to repay the note to Terrance.

In **December** 2015, the bank called the balance of the line of credit. Forts4U was unable to pay the loan, so Terrance had to pay the balance of \$75,000 as the guarantor. Because the corporation was essentially insolvent at the time, this cash infusion was treated as an addition to capital and not as a loan from Terrance.

The Schedule K-1 Terrance received from Forts4U for 2015 showed \$0 ordinary income/loss and \$50,000 on line 16, code E ("repayment of loans from shareholders"). There were no other entries on the K-1. The tax effects of Terrance's transactions with the corporation for 2015 are as follows.

Stock basis:

Basis as of 12/31/14	\$ 0
Plus: payment of bank loan	75,000
End of 2015 stock basis	\$75,000

Loan basis:

Basis as of 12/31/14	\$ 0
Less: repayments received	(50,000)
Negative subtotal = payments in excess of basis	(\$50,000)
Plus: taxable repayments in excess of basis	50,000
End of 2015 loan basis	\$ 0

Terrance had to recognize \$50,000 of income on his 2015 return from the repayment of the note. His subsequent capital contribution of \$75,000 had no effect on this recognition of income.

⁴² *Nathel v. Comm'r*, 131 TC 262 (2008).

Observations for Example 18.

1. Because the debt at the end of 2014 was more than \$25,000, it could not be treated as open-account debt regardless of whether it was properly documented. Therefore, structuring the subsequent cash infusion as another loan instead of a capital contribution would not have remedied the situation; each debt (whether documented or undocumented) had to be tracked separately.
2. If the debt is **undocumented**, the 2015 repayments are taxed as ordinary income.
3. If the debt is **documented**, the 2015 repayments are taxed as capital gain income.

Note. See the “Documented Versus Undocumented Loans” section earlier in the chapter.

4. When an S corporation has experienced operating losses and liquidates operations at a time when the shareholder has suspended losses and zero basis, the shareholder’s basis can be increased by contributing capital, thus allowing those losses to be used on their individual return.

SOFTWARE LIMITATIONS

Note. It is important for tax practitioners to ask clients all relevant questions related to material participation and at-risk limitations in order to ensure that these limitations are reflected in the software.

Not all professional tax preparation software tracks basis and applies the applicable limits. Moreover, making basis calculations requires the tax preparer to apply information that is not reported on the taxpayer’s Schedule K-1. Although it is possible to properly report S corporation activity without knowing the taxpayer’s basis, it is not possible to do so every year. It is impossible to do so in the final year that the taxpayer is a shareholder in the corporation.

Capital infusions and loans **to the corporation** are not reported on Schedule K-1. Even if the preparer of the corporate tax return provides basis information, the preparer of the shareholder’s personal return should **make inquiries** to determine that the basis information is correct.

The following chart is provided to assist practitioners who use software that does not categorize all Schedule K-1 entries into basis tiers. It shows which basis tiers apply to entries on Schedule K-1.

Tier 1. Items of Income

- Ordinary income
- Net rental income
- Interest income (taxable and tax-exempt)
- Dividends (taxable and tax-exempt)
- Capital gains
- Royalty income
- Net §1231 gains
- Nontaxable municipal interest income
- Any other income shown on the Schedule K-1
- The excess of the deductions for depletion over the basis of the property subject to depletion (except for oil and gas properties)⁴³

⁴³ IRC §1367(a)(1)(C).

Tier 2. Distributions

Tier 3. Nondeductible Expenses (Optional Tier 4 if special ordering election made)

- Disallowed meals and entertainment
- Expenses related to tax-exempt income
- Life insurance premiums
- Timing difference of transactions between accrual-basis corporations and cash-basis shareholders (This can be a positive or negative adjustment.)

Tier 4. Deductible Losses and Other Expenses (Optional Tier 3 if special ordering election made)

- Ordinary losses
- Net rental losses
- Capital losses
- Net §1231 losses
- §179 deduction
- Charitable contributions
- Investment expenses
- Investment interest expense
- Depletion for any oil and gas property held by the S corporation to the extent the deduction does **not** exceed the proportionate share of the adjusted basis of the property allocated to the shareholder⁴⁴

The following Schedule K-1 shows which tiers apply to various entries for income and expenses. The tier numbers shown in parentheses apply to negative entries. A worksheet is also provided to assist the preparer in ensuring that proper entries are made on the Schedule K-1.

Note. A separate worksheet should be maintained using the alternative minimum tax (AMT) adjustments in box 15 to track the shareholder's basis for AMT purposes.

⁴⁴ IRC §1367(a)(2)(E).

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

Department of the Treasury
Internal Revenue Service

2015

For calendar year 2015, or tax
year beginning _____, 2015
ending _____, 20____

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

► See back of form and separate instructions.

☐ Final K-1

☐ Amended K-1

OMB No. 1545-0123

Part I Information About the Corporation		Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items	
A Corporation's employer identification number		1 Ordinary business income (loss) Tier 1 or (Tier 4)	13 Credits Code O: Tier 2
B Corporation's name, address, city, state, and ZIP code		2 Net rental real estate income (loss) Tier 1 or (Tier 4)	
		3 Other net rental income (loss) Tier 1 or (Tier 4)	
C IRS Center where corporation filed return		4 Interest income Tier 1	
		5a Ordinary dividends Tier 1	
		5b Qualified dividends Not applicable	14 Foreign transactions Not applicable
		6 Royalties Tier 1	
		7 Net short-term capital gain (loss) Tier 1 or (Tier 4)	
		8a Net long-term capital gain (loss) Tier 1 or (Tier 4)	
		8b Collectibles (28%) gain (loss) Not applicable	
		8c Unrecaptured section 1250 gain Not applicable	
D Shareholder's identifying number		9 Net section 1231 gain (loss) Tier 1 or (Tier 4)	
E Shareholder's name, address, city, state, and ZIP code		10 Other income (loss) Tier 1 or (Tier 4)	15 Alternative minimum tax (AMT) items Code A: T1 or (T4)
			Code B: T1 or (T4)
			Code C: Tier 4
			Code D: Tier 1
			Code E: Tier 4
		11 Section 179 deduction Tier 4	16 Items affecting shareholder basis Code A: Tier 1
		12 Other deductions Codes A-O: Tier 4	Code B: Tier 1
		Codes P-R: Not applic.	Code C: Tier 3
		Code S: Tier 4	Code D: Tier 2
			Code E: Loan Basis
			17 Other information Codes K&L: Tier 1
			Code Q: Tier 2
			Code R: Tier 4
* See attached statement for additional information.			

AMT basis only

For Paperwork Reduction Act Notice, see Instructions for Form 1120S.

IRS.gov/form1120s

Cat. No. 11520D

Schedule K-1 (Form 1120S) 2015

S Corporation Stockholder Basis Carryforward Optional Ordering Election Not Made

2

	Stock Basis	Loan Basis
Basis at beginning of year		
Plus: additional contributions during year		
Plus: Tier 1 income and gains from K-1 box: ^a		
1		
2		
3		
4		
5a		
6		
7		
8a		
9		
10 Code A		
10 Code B		
10 Code C		
10 Code D		
10 Code E		
16 Code A		
16 Code B		
17 Code K		
17 Code L		
Income subtotal		
Income items added to basis ^b		
Subtotal 1		
Less: Tier 2 payments received	16 Code D	16 Code E
Less: Tier 2 backup withholding	13 Code O	
Subtotal 2 ^c		
Total: larger of subtotal 2 or \$0 ^d		

^a Negative entries on the K-1 go to Tier 4.

^b Amount up to reduced basis debt existing at beginning of year should be entered in Loan Basis column, with any remainder entered in Stock Basis column.

^c If subtotal 2 is negative, the taxpayer must recognize income.

^d Basis cannot be negative.

2016 Workbook

S Corporation Stockholder Basis Carryforward Optional Ordering Election Not Made (Continued)

	Stock Basis	Loan Basis	Carryforwards
Total from page 1	_____	_____	
Less: Tier 3 nondeductible expenses:			
Prior year carryforward	_____		
16 Code C	_____		
Tier 3 subtotal	_____		
Subtotal 3 ^a	_____	_____	_____
Larger of Subtotal 3 or \$0	_____	_____	
Less: Tier 4 deductible expenses and losses:			
Prior year carryforward	_____		
K-1 box:			
1	_____		
2	_____		
3	_____		
7	_____		
8a	_____		
9	_____		
10 Code A	_____		
10 Code B	_____		
10 Code C	_____		
10 Code D	_____		
10 Code E	_____		
11	_____		
12 Codes A through O, S	_____		
17 Code R	_____		
Tier 4 subtotal	_____		
Subtotal 4 ^b	_____	_____	_____
Larger of Subtotal 4 or \$0	_____	_____	

^a Enter tier 3 subtotal in Stock Basis column to the extent that stock basis after subtracting tier 2 expenses is positive.

^b Enter tier 4 subtotal in Stock Basis column to the extent that stock basis after subtracting tier 3 expenses is positive. If this subtotal is negative, the Tier 4 expenses carry forward to the next year.

ALTERNATIVE MINIMUM TAX BASIS

2

Adjustments and preferences for AMT purposes are reported separately on Schedule K-1. A shareholder must use these reported items to determine if they owe AMT in the current year.

A shareholder must track their basis in the S corporation shares for AMT purposes in addition to tracking their basis for regular tax purposes. The adjustment for depreciation of assets placed in service after 1986 is one of the most common adjustments passed through to shareholders.

Example 19. In 2015, Holly Clearly purchased 100 shares of 3Moons Inc., an S corporation, for \$30,000. On her 2015 Schedule K-1, the corporation reported ordinary income of \$20,000 and an AMT adjustment of \$10,000 in box 15, code A (“post-1986 depreciation adjustment”). Holly reported this \$10,000 adjustment as an addition to AMT income on her 2015 Form 6251, *Alternative Minimum Tax – Individuals*. Holly’s basis at the end of 2015 for regular tax and AMT purposes is calculated as follows.

	Regular Income Tax	AMT
Purchase price of shares	\$30,000	\$30,000
2015 income	20,000	20,000
AMT adjustment		10,000
Share basis at the end of 2015	\$50,000	\$60,000

On January 1, 2016, Holly sold her 3Moons shares for \$75,000. Under IRC §1377(a)(2), if a shareholder terminates their interest in the corporation during the tax year and all affected shareholders and the corporation agree, the corporation can elect to report each shareholder’s pro-rata share of the corporation’s activity as if the tax year consisted of two tax years — the first of which ends on the date of the termination.

The shareholders of 3Moons agreed, and the corporation elected to report each shareholder’s share of the corporation’s activity as if the tax year consisted of two tax years — the first of which ended on January 1, 2016.⁴⁵ Therefore, Holly’s 2016 Schedule K-1 does not show any pass-through activity for her to report on her 2016 return.

For regular tax purposes, Holly reports a short-term gain of \$25,000 on her 2016 return (\$75,000 sale price – \$50,000 basis). For AMT purposes, her gain is only \$15,000 (\$75,000 – \$60,000 basis.) The \$10,000 difference between her gains under the two tax regimes is reported as a subtraction on her 2016 Form 6251.

SHAREHOLDER EXPENSES

A shareholder may have deductible expenses related to their ownership of an S corporation. Although a partner in a partnership can claim these expenses on Schedule E, *Supplemental Income and Loss*, this provision does not apply to an S corporation shareholder.

Ideally, the S corporation should reimburse the shareholder for out-of-pocket expenses. This includes expenses the shareholder incurred when the S corporation was in the formation stage, such as start-up expenses. However, in some situations, management may not want to reimburse the shareholder-employee for expenses it deems excessive or unnecessary.

⁴⁵ See IRC §1377(a)(2).

OUT-OF-POCKET EXPENSES IN GENERAL

A shareholder who personally pays unreimbursed expenses on behalf of the S corporation can claim a personal deduction for these expenses. However, expenses related to **owning the shares** are only deductible as investment expenses on Schedule A, *Itemized Deductions*. Such expenses are miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) threshold. These expenses include investment advisory fees, safe deposit box rental fees for storage of stock certificates, and other expenses directly related to owning the stock.⁴⁶

Unreimbursed expenses related to the shareholder's role as **an employee** (such as mileage, lodging, meals, etc.) should be reported on Form 2106, *Employee Business Expenses*, and carried to Schedule A as miscellaneous itemized deductions subject to the 2% of AGI threshold.⁴⁷

The taxpayer should retain supporting documents that show the amounts paid and provide evidence that the expenditures were for a business or investment use. Such documentation includes credit card receipts, cash register receipts, petty cash slips, and account statements from vendors. Travel, entertainment, gift, and transportation expenses **must** be documented in specific ways according to the Code and the underlying regulations.⁴⁸ For more information see IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*.

The taxpayer should have supporting documents available in case of an audit. However, unless the Code specifically requires certain types of substantiation, the courts may allow the taxpayer to deduct undocumented expenses when, based on testimony and other evidence, the court believes the taxpayer.⁴⁹

OPERATING OUT OF A SHAREHOLDER'S HOME

An S corporation may base its operations out of a shareholder–employee's home. Unreimbursed expenses related to a home office can be deducted by the shareholder–employee on Form 2106 and carried to Schedule A as miscellaneous itemized deductions subject to the 2% of AGI threshold. The deduction for business use of the home is subject to the exclusive use or principal place of business test and income limitation found in IRC §280A.⁵⁰

In general, if the S corporation pays rent to the shareholder for the use of real estate, the rent is deductible by the corporation and is income to the shareholder. In most rental situations, the shareholder claims normal expenses against this rental income. However, if the rent is paid for use of 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.⁵¹

Note. The S corporation may be able to **reimburse** the shareholder–employee for expenses related to the operation of their office. Unfortunately, the Code, regulations, rulings, and courts have not outlined what expenses are reimbursable in this situation. For more information, see the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: S Corporation Entity Issues.

INTEREST PAID ON A LOAN TO BUY STOCK

A taxpayer who borrows money to buy stock in an S corporation can claim a deduction for interest paid on the loan. The classification of this interest depends on whether the taxpayer purchased the shares from the S corporation or from another shareholder.⁵²

⁴⁶ IRS Pub. 550, *Investment Income and Expenses*.

⁴⁷ Instructions for Schedule A.

⁴⁸ IRC §274.

⁴⁹ *Lerch v. Comm'r*, 877 F.2d 624 (7th Cir. 1989).

⁵⁰ *Cunningham v. Comm'r*, TC Memo 1996-141 (Mar. 20, 1996).

⁵¹ IRC §§280A(b), (c)(6).

⁵² IRS Notice 88-37, 1988-1 CB 522; IRS Notice 89-35, 1989-1 CB 675.

If the taxpayer makes a capital contribution to the S corporation in **exchange for stock**, the interest expense is allocated **using any reasonable method, including methods based on assets owned by the corporation or methods based on the actual use of the debt proceeds by the corporation**. If the taxpayer purchases S corporation stock **from another shareholder**, the interest expense is allocated according to any reasonable method that is **based on the assets** of the corporation. Such methods may include pro-rata allocation based on the assets' FMVs, book values, or adjusted bases. Use of a method based on anything other than the assets is not allowed.

Once the interest expense is allocated, the expense attributed to each type of use is reported on the shareholder's Form 1040, *U.S. Individual Income Tax Return*, as follows.

- **Nonpassive business operation** — The interest is reported on Schedule E, page 2, with the name of the S corporation and the description of "interest expense."
- **Passive operation** — The interest is reported on Form 8582, *Passive Activity Loss Limitations*. If there is sufficient passive income to allow the deduction, the expense flows to Schedule E, page 2.
- **Investment** — The interest is reported on Schedule A, line 14 ("investment interest"). In some cases, completing Form 4952, *Investment Interest Expense Deduction*, may also be required.

Example 20. In 2016, Adelle Stackhome purchases 1,000 shares of stock directly from Glorious Memories Inc. (Glorious), an S corporation. She borrows \$50,000 of the funds she uses for the purchase. Glorious spends the money to purchase a new building to house its for-profit museum. Adelle materially participates in the corporation's business. Based on the corporation's use of the money, Adelle deducts 100% of the loan interest that she pays in 2016 on Schedule E.

Note. If Adelle did not materially participate in the corporation's activities, the interest would be reported on Form 8582.

Example 21. Use the same facts as **Example 20**. In 2017, Adelle purchases another block of Glorious shares with borrowed funds. However, she purchases these shares from another shareholder. At the time of the purchase, half of Glorious's assets are used in its operations and the other half are used as rental property, which by definition is passive. Adelle must prorate the deduction based on the corporation's assets because she did not purchase the shares from the corporation. In this situation, her deduction for the interest expense on the new loan is divided equally between Schedule E and Form 8582.

THE IRC §179 DEDUCTION

The limitations applicable to IRC §179 deductions apply at both the corporate **and the shareholder levels**. For most property placed in service in a tax year beginning in 2016, the total amount a taxpayer can elect to deduct under IRC §179 generally cannot be more than \$500,000.⁵³

The following circumstances affect the general limits for the §179 deduction.

1. If the cost of qualifying §179 property placed in service in 2016 is more than \$2,010,000,⁵⁴ the taxpayer must reduce the \$500,000 limit on a dollar-for-dollar basis by the amount in excess of \$2,010,000. If the cost of §179 property placed in service during 2016 is \$2,510,000 or more, the taxpayer cannot take a §179 deduction.
2. If the taxpayer is married, the taxpayer and their spouse are treated as one taxpayer with respect to the §179 limits. Taxpayers filing separately must allocate the limits between them.

⁵³ Rev. Proc. 2016-14, 2016-9 IRB 365.

⁵⁴ Ibid.

The total cost that the taxpayer can deduct each year after applying the dollar **limits** is restricted to the **taxable income** from the **active conduct** of any trade or business during the year.⁵⁵ Generally, **active conduct** means meaningful participation in the management or operation of the trade or business.⁵⁶ The term **trade or business** has the same general meaning as used throughout the Code.⁵⁷ Property held merely for the production of income or used in an activity not engaged in for profit (a hobby) does not qualify.⁵⁸ Furthermore, income derived from passive investments and hobbies is not taken into account in determining the taxable income limitation.

Note. The Code specifically uses the term **active** with respect to the taxpayer's participation requirement in activities taken into account for purposes of the §179 deduction. This is a lesser standard than **material** participation. **Material participation** is defined later in the "Passive Activity Loss Rules" section of this chapter. For more information about material participation, see the 2014 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: Passive Activities. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

Shareholders calculate their allowable §179 deduction on Form 4562, *Depreciation and Amortization*. The amount of business income from the S corporation taken into account for purposes of the §179 business-income limitation includes all items of income and expenses passed through to the shareholder **except** the following.

1. Tax-exempt income
2. The §179 deduction
3. The deduction for compensation paid to the corporation's shareholder-employees⁵⁹

Example 22. Zeke Ivanek is the 100% shareholder in Magister's LLC (Magister's), which elected S corporation status for tax purposes. In 2016, Zeke earns \$200,000 in wages from the company. His Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc.*, from Magister's reports a \$10,000 ordinary business loss and a \$50,000 §179 deduction. Zeke's business income for purposes of the §179 deduction is \$190,000 (\$200,000 wages – \$10,000 business loss).

If the shareholder materially participates in the S corporation's activities, the §179 amount reported on Form 4562 is carried to page 2 of Schedule E. If the shareholder **does not materially participate** in the S corporation's activities but **does actively participate**, the amount from Form 4562 is carried to Form 8582, where it is subject to the passive activity limitations.

⁵⁵ IRC §179(b)(3)(A).

⁵⁶ Treas. Reg. §1.179-2(c)(6)(ii).

⁵⁷ Treas. Reg. §1.179-2(c)(6)(i).

⁵⁸ Ibid.

⁵⁹ Instructions for Form 4562.

If shareholders neither actively nor materially participate in the S corporation's activities, they cannot use the §179 deduction that passed through from the S corporation. Treas. Reg. §1.179-2(c)(6)(ii) states the following.

In the context of section 179, the purpose of the active conduct requirement is to prevent a passive investor in a trade or business from deducting section 179 expenses against taxable income derived from that trade or business.

Note. Because of the many provisions that limit individuals under the passive loss rules, the regulations provide a number of specific tests regarding active and material participation requirements. S corporations are not subject to the same material participation tests that apply to individuals, and the regulations do not provide any specific tests. Logically, a corporation generally meets the active conduct test if the business is operated by the corporation. However, if the S corporation **merely** owns an investment in another pass-through entity, the corporation will not meet the active conduct test with respect to that other entity.

Example 23. Roman Park owns 25% of the outstanding shares of Largo's Guardian Corporation (Largo's), an S corporation. Largo's meets the requirement of **actively conducting** its business. However, Roman is involved strictly as an investor; he does not participate at all in the company's operations. The remaining shareholders actively and materially participate in the company.

In 2013, the Schedule K-1 that Roman received from Largo's showed \$50,000 of operating income and \$45,000 of §179 deduction. Roman reported the entire \$50,000 as taxable passive income on his 2013 tax return. He was not eligible to use the §179 deduction that was passed through to him.

If shareholders are not allowed to use the §179 deduction because they fail the active participation test, the disallowed §179 deduction is suspended until the asset is disposed of or the shareholders' shares in the corporation are disposed of.

An S corporation does not use Form 4797, *Sales of Business Property*, to report the sale or other disposition of property if the §179 deduction for that property was previously passed through to any of its shareholders. Instead, the corporation reports the disposition in box 17 ("other information") of Schedule K-1 using code K.⁶⁰ The corporation is also required to provide its shareholders with detailed information about the disposition of the asset so that the shareholders can properly report the disposition on their Forms 4797. Each shareholder calculates the depreciation allowed or allowable to report on Form 4797 using the following formula.⁶¹

$$\begin{array}{r}
 \text{Depreciation allowed or allowable (as reported by the S corporation to the shareholder)} \\
 + \text{ The §179 expense deduction} \\
 - \text{ Any unused carryover of the §179 deduction for this property} \\
 \hline
 \text{Depreciation allowed or allowable to report on Form 4797}
 \end{array}$$

Note. The amounts used in this calculation may be different from the amount of §179 expense the shareholder deducted for the property if their interest in the corporation changed.

⁶⁰ Instructions for Form 1120S.

⁶¹ Shareholder's Instructions for Schedule K-1 (Form 1120S).

2016 Workbook

Example 24. Use the same facts as **Example 23**. In 2015, Largo's sold the asset for which it had elected the §179 deduction in 2013. Roman received the following information with his 2015 Schedule K-1, which also showed \$50,000 of ordinary income for 2015.

Shareholder's Disposition Report for Assets with §179 Elections

Date surveillance system purchased	03/01/2013
Date surveillance system sold	08/25/2015
Gross sales price	\$ 5,000
Cost basis	45,000
Depreciation allowed or allowable at S corporation level	0
IRC §179 election	45,000
Tax year of election	2013

On Roman's 2015 return, he reports the sale of the asset for \$5,000 on Form 4797. The amount he must report for depreciation allowed or allowable is calculated as follows.

Corporate depreciation allowed or allowable	\$ 0
Plus: IRC §179 expense deduction	45,000
Less: any unused carryover of the IRC §179 deduction for this property	(45,000)
Shareholder's depreciation allowed or allowable	\$ 0

Roman reports this transaction on Form 4797. His loss on the sale of the asset is netted against his income from the activity on Form 8582. These forms follow.

For Example 24

Form 4797 Department of the Treasury Internal Revenue Service	Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2)) ▶ Attach to your tax return. ▶ Information about Form 4797 and its separate instructions is at www.irs.gov/form4797 .	OMB No. 1545-0184 <div style="font-size: 2em; font-weight: bold;">2015</div> Attachment Sequence No. 27					
Name(s) shown on return Roman Park		Identifying number 255-66-1111					
1 Enter the gross proceeds from sales or exchanges reported to you for 2015 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions) 1							
Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)							
2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
	Surveillance system	03/01/2013	08/25/2015	5,000	0	45,000	(40,000)
3	Gain, if any, from Form 4684, line 39						3
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37						4
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824						5
6	Gain, if any, from line 32, from other than casualty or theft.						6
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:						(40,000)
Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.							
Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.							
8	Nonrecaptured net section 1231 losses from prior years (see instructions)						8
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)						0
Part II Ordinary Gains and Losses (see instructions)							
10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):							
11	Loss, if any, from line 7						(40,000)
12	Gain, if any, from line 7 or amount from line 8, if applicable						12
13	Gain, if any, from line 31						13
14	Net gain or (loss) from Form 4684, lines 31 and 38a						14
15	Ordinary gain from installment sales from Form 6252, line 25 or 36						15
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824.						16
17	Combine lines 10 through 16						(40,000)
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:						
a If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions . . .						18a	
b Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14						(40,000)	

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 130861

Form **4797** (2015)

2016 Workbook

For Example 24

Form 8582 Department of the Treasury Internal Revenue Service (99)	Passive Activity Loss Limitations ▶ See separate instructions. ▶ Attach to Form 1040 or Form 1041. ▶ Information about Form 8582 and its instructions is available at www.irs.gov/form8582 .	OMB No. 1545-1008 <div style="font-size: 2em; font-weight: bold; margin: 5px 0;">2015</div> Attachment Sequence No. 88
Name(s) shown on return Roman Park		Identifying number 255-66-1111
Part I 2015 Passive Activity Loss Caution: Complete Worksheets 1, 2, and 3 before completing Part I.		
Rental Real Estate Activities With Active Participation (For the definition of active participation, see Special Allowance for Rental Real Estate Activities in the instructions.)		
1a Activities with net income (enter the amount from Worksheet 1, column (a))	1a	
b Activities with net loss (enter the amount from Worksheet 1, column (b))	1b ()	
c Prior years unallowed losses (enter the amount from Worksheet 1, column (c))	1c ()	
d Combine lines 1a, 1b, and 1c	1d	
Commercial Revitalization Deductions From Rental Real Estate Activities		
2a Commercial revitalization deductions from Worksheet 2, column (a) .	2a ()	
b Prior year unallowed commercial revitalization deductions from Worksheet 2, column (b)	2b ()	
c Add lines 2a and 2b	2c ()	
All Other Passive Activities		
3a Activities with net income (enter the amount from Worksheet 3, column (a))	3a 50,000	
b Activities with net loss (enter the amount from Worksheet 3, column (b))	3b (40,000)	
c Prior years unallowed losses (enter the amount from Worksheet 3, column (c))	3c ()	
d Combine lines 3a, 3b, and 3c	3d 10,000	
4 Combine lines 1d, 2c, and 3d. If this line is zero or more, stop here and include this form with your return; all losses are allowed, including any prior year unallowed losses entered on line 1c, 2b, or 3c. Report the losses on the forms and schedules normally used		4 10,000
If line 4 is a loss and: <ul style="list-style-type: none"> • Line 1d is a loss, go to Part II. • Line 2c is a loss (and line 1d is zero or more), skip Part II and go to Part III. • Line 3d is a loss (and lines 1d and 2c are zero or more), skip Parts II and III and go to line 15. 		

Caution: If your filing status is married filing separately and you lived with your spouse at any time during the year, **do not** complete Part II or Part III. Instead, go to line 15.

Special Allowance for Rental Real Estate Activities With Active Participation

Observation for Example 24.

If Roman did not have sufficient passive income to absorb the loss, Form 4797, line 2, column (g) would be reduced by the amount of suspended passive loss in excess of passive income for 2015.

Note. Information is provided earlier in the chapter on how the §179 deduction affects basis and the treatment of a suspended §179 deduction when the shareholder disposes of their stock.

NET INVESTMENT INCOME TAX

The net investment income tax (NIIT) applies to investment income above certain thresholds. S corporation income is subject to this tax if the taxpayer **does not materially** participate in the operations of the company. Income from the Schedule K-1 is generally included on line 4a of Form 8960, *Net Investment Income Tax – Individuals, Estates, and Trusts*. Income from dispositions of property that are reported on Schedule K-1 is included on line 5a.

If the taxpayer **materially** participates in the activity of the S corporation, an adjustment must be made on lines 4b and 5b to subtract the S corporation income not subject to the NIIT.⁶²

Example 25. Sarah Newton owns shares in Newton Publishing, Inc. (Newton), an S corporation. She works full time promoting Newton's publications. Her 2015 Schedule K-1 showed ordinary income of \$1 million, a net IRC §1231 gain of \$50,000, and an §179 deduction of \$10,000. On Form 8960, the ordinary income and the §179 deduction were netted and reported on line 4a (\$1 million – \$10,000 = \$990,000). The §1231 gain was reported on line 5a.

To show that these items of income were not subject to the NIIT, the qualifying excluded amounts were reported on lines 4b and 5b, respectively. The relevant portion of Sarah's 2015 Form 8960 follows.

Form 8960		Net Investment Income Tax— Individuals, Estates, and Trusts		OMB No. 1545-2227	
Department of the Treasury Internal Revenue Service (99)		▶ Attach to your tax return. ▶ Information about Form 8960 and its separate instructions is at www.irs.gov/form8960 .		2015 Attachment Sequence No. 72	
Name(s) shown on your tax return Sarah Newton				Your social security number or EIN 111-22-1111	
Part I Investment Income		<input type="checkbox"/> Section 6013(g) election (see instructions) <input type="checkbox"/> Section 6013(h) election (see instructions) <input type="checkbox"/> Regulations section 1.1411-10(g) election (see instructions)			
1	Taxable interest (see instructions)	1			
2	Ordinary dividends (see instructions)	2			
3	Annuities (see instructions)	3			
4a	Rental real estate, royalties, partnerships, S corporations, trusts, etc. (see instructions)	4a	990,000		
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b	(990,000)		
c	Combine lines 4a and 4b	4c			0
5a	Net gain or loss from disposition of property (see instructions)	5a	50,000		
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b	(50,000)		
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c			
d	Combine lines 5a through 5c	5d			0
6	Adjustments to investment income for certain CFCs and PFICs (see instructions)	6			
7	Other modifications to investment income (see instructions)	7			
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7	8			0
Investment Expenses Allocable to Investment Income and Modifications					

Note. Taxpayers frequently engage in multiple activities through a single S corporation. The taxpayer may materially participate in only some of these activities. This results in a shareholder receiving both active and passive income from the same S corporation. A separate accounting of active and passive income is necessary for NIIT purposes.

⁶² Instructions for Form 8960.

CORPORATE-LEVEL ISSUES: EFFECTS ON SHAREHOLDERS

An S corporation must report relevant tax information to shareholders, employees, and other parties with which it does business. A shareholder should always receive a Schedule K-1 from the S corporation. The shareholder should also receive a Form W-2, *Wage and Tax Statement*, if they are an employee of the corporation.

In addition, shareholders may receive other tax documents depending on the transactions they had with the corporation during the year. This section covers certain issues related to various tax documents that shareholders may receive.

Note. Understanding the transactions behind the tax documents that a shareholder receives from an S corporation may alert the tax preparer about issues regarding basis calculations that are relevant to the individual shareholder's return. For example, a Form 1099-INT, *Interest Income*, indicates the existence of a shareholder loan to the corporation.

FORM W-2: HEALTH INSURANCE AND MEDICAL REIMBURSEMENT PLANS

S corporation shareholder-employees must pay income taxes on fringe benefits if they own more than 2% of the stock in the corporation. Most fringe benefits reported on Form W-2 are taxable, but those related to health insurance and medical reimbursement plans give rise to offsetting deductions.

Health insurance premiums paid by the S corporation on behalf of its (more than) 2% shareholders in consideration for services rendered are included in wages for income tax withholding purposes on the shareholder-employees' Forms W-2.⁶³ The premiums are **not** subject to social security and Medicare taxes if the reimbursement arrangement meets the requirements for exclusion under IRC §3121(a)(2)(B).⁶⁴

Note. The amount of health insurance may be reported in box 14. However, the employer is **not required** to indicate on Form W-2 the amount of health insurance premiums included in wages. If a Form W-2 does not show the amount paid for health insurance but the amount of wages subject to income tax is higher than the amounts subject to social security and/or Medicare taxes, the practitioner should make further inquiries about the existence of deductible health insurance premiums.

A 2% shareholder-employee is allowed a deduction for self-employed health insurance. The S corporation must have either paid the premiums directly or reimbursed the shareholder-employee for the premiums paid by the individual. In addition, the S corporation must report the premiums on the individual's Form W-2 for the year they were paid.

The self-employed health insurance deduction is generally limited to the amount of net income from the self-employment activity. **For a 2% shareholder, this limit is determined by the amount of wages subject to Medicare taxes.**

The self-employed health insurance deduction is not allowed for amounts paid that covered any month the taxpayer was eligible to participate in a subsidized health plan maintained by their employer or their spouse's employer.⁶⁵

Note. If a 2% shareholder is allowed both the above-the-line deduction for health insurance premiums and the premium tax credit, see Rev. Proc. 2014-41 for guidance on computing the deduction and the credit.

⁶³ IRS Notice 2008-1, 2008-2 IRB 1.

⁶⁴ Ibid.

⁶⁵ IRC §162(l)(2)(B).

FORM 1099-DIV

A shareholder in an S corporation may receive a Form 1099-DIV, if the S corporation was a C corporation before electing S corporation status. The corporation may have accumulated earnings and profits (AEP) from the time it was a C corporation. If so, some or all of the distribution received by a shareholder may be taxable as a dividend until AEP is exhausted. **These dividends do not reduce basis.**

In very rare circumstances, Form 1099-DIV may also show nondividend distributions to the shareholder. These distributions should be included in the calculation of basis. To the extent that distributions exceed the shareholder's basis in the S corporation stock, they are taxable.⁶⁶

THE THREE LOSS LIMITATIONS

Three different sets of rules may limit the amount of a loss deductible by an S corporation shareholder. These limitations, **in the order in which they are applied**, are as follows.

1. The **stock and debt basis** limitation under IRC §1366(d) (discussed earlier in this chapter)
2. The **at-risk** rules under IRC §465
3. The **passive activity loss** rules under IRC §469

AT-RISK RULES

The appropriate time to calculate at-risk basis is at the end of the S corporation's tax year.⁶⁷ In applying the at-risk rules:

... substance will prevail over form. Regardless of the form a transaction may take, the taxpayer's amount at risk will not be increased if the transaction is inconsistent with normal offset commercial practices or is, in essence, a device to avoid [the at-risk rules of] section 465.⁶⁸

The at-risk rules are similar to the basis rules. **Losses limited under both rules are carried forward until the taxpayer has sufficient basis to claim the deferred losses.**

Generally, transactions that add to the **stock basis** also add to the amount of financial risk shareholders bear from their investment in the S corporation. However, if the shareholder does not bear any true economic risk, the transaction is disregarded under the at-risk rules. One example of this is shares purchased with borrowed funds when the shares are used as collateral for the loan. Money borrowed from someone who also holds an interest in the S corporation's profits or equity also does not qualify as an amount at risk for the shareholder who uses the loan to purchase shares in the corporation.⁶⁹

The rules for money loaned to an S corporation are less stringent than those for money used to buy stock in an S corporation. For debt purposes, the amount at risk can include loans the shareholder made to the company even if the funds were borrowed from other shareholders in the same corporation.

⁶⁶ IRC §1368(b)(2).

⁶⁷ Prop. Treas. Reg. §1.465-1(a).

⁶⁸ Prop. Treas. Reg. §1.465-1(b).

⁶⁹ Treas. Reg. §§1.465-8(a) and 1.465-20(a).

2016 Workbook

Another distinction between the basis and at-risk rules involves the manner in which the amounts of allowed losses are determined when multiple categories of losses are subject to the limitations.

- **For basis purposes**, deductible items and nondeductible losses are considered separately under their own tiers. When basis limitations apply, each tier absorbs basis until the next is considered. (See the “Ordering Rules” section earlier in the chapter.)
- **When at-risk limitations apply**, the excess is prorated between deductible and nondeductible items.⁷⁰

The following examples illustrate the differences between the basis and at-risk limitations.

Example 26. In 2015, Debby Pelts purchased stock in CrazyShots Inc., an S corporation, for \$10,000. The funds used for the purchase came from her savings, so they qualify for both basis and at-risk purposes. The 2015 Schedule K-1 Debby received showed an ordinary loss of \$18,500 in box 1 and nondeductible expenses of \$1,500 in box 16, code C (“nondeductible expenses”). Debby had previously made a Treas. Reg. §1.1367-1(g) election to consider deductible losses prior to nondeductible expenses. She had not made any loans to the corporation.

For basis purposes, Debby’s deductible loss is calculated as follows. She is allowed to deduct \$9,250 of ordinary losses on her 2015 return. Although she qualifies to deduct \$10,000 under the basis rules, her deduction is limited under the at-risk rules.

Calculation of Debby’s loss as limited by basis:

	Additions to basis (stock purchase)	\$10,000
Tier 1	Items of Income	0
Tier 2	Distributions	0
Optional Tier 3	Less: deductible losses	(18,500)
	Negative subtotal = deductible losses in excess of basis ^a	(\$ 8,500)
	Deductible losses carried forward to future years	8,500
	Remaining basis before consideration of nondeductible expenses	\$ 0
Optional Tier 4	Less: nondeductible expenses/losses	(1,500)
	Negative subtotal = nondeductible expenses in excess of basis	(\$ 1,500)
	Nondeductible expenses carried forward to future years	1,500
	Remaining basis at the end of 2015	\$ 0

^a \$10,000 allowed.

Calculation of Debby’s loss as limited by the at-risk rules:

	Deductible		Nondeductible		Total	
Expenses/losses from K-1		\$18,500		\$1,500		\$20,000
Total at risk	\$10,000		\$10,000		\$10,000	
Percentage of total	× 92.5%		× 7.5%		× 100%	
At-risk expenses allowed in 2015	\$ 9,250	(9,250)	\$ 750	(750)	\$10,000	(10,000)
K-1 expenses carried forward		\$ 9,250		\$ 750		\$10,000

⁷⁰ IRS Pub. 925, *Passive Activity and At-Risk Rules*.

Example 27. In 2015, Juan purchased stock in WR Contractors Inc. (WR), an S corporation, for \$20,000. Half of the funds used for the purchase came from his savings, and the other half came from his father, who owns the rest of the shares of the corporation. The 2015 Schedule K-1 Juan received shows an ordinary loss of \$18,500 in box 1 and nondeductible expenses of \$1,500 in box 16 (code C).

Juan's \$20,000 investment established sufficient basis to allow the full \$18,500 of ordinary loss and absorb the \$1,500 in nondeductible expenses. However, only the \$10,000 from Juan's savings qualified for **at-risk** purposes. The amount of deductible and nondeductible losses was prorated as follows.

	Deductible		Nondeductible		Total	
Expenses/losses from K-1		\$18,500		\$1,500		\$20,000
Total at risk	\$10,000		\$10,000		\$10,000	
Percentage of total	$\times 92.5\%$		$\times 7.5\%$		$\times 100\%$	
At-risk expenses allowed in 2015	\$ 9,250	(9,250)	\$ 750	(750)	\$10,000	(10,000)
K-1 expenses carried forward		\$ 9,250		\$ 750		\$10,000

Juan was allowed to deduct \$9,250 of the deductible losses and \$750 of nondeductible expenses on his 2015 personal return. The remaining \$9,250 of deductible losses and \$750 of nondeductible expenses were carried forward to his 2016 return.

At-Risk Filing Requirement

An S corporation shareholder is required to file Form 6198, *At-Risk Limitations*, when the losses exceed the amount at risk in a trade or business activity. This form is used to show the annual adjustments made each year to the at-risk basis and to disclose such adjustments to the IRS.

2016 Workbook

Example 28. Use the same facts as **Example 27**. Juan files the following Form 6198 with his 2015 return.

Form 6198 (Rev. November 2009) Department of the Treasury Internal Revenue Service	At-Risk Limitations ▶ Attach to your tax return. ▶ See separate instructions.	OMB No. 1545-0712 Attachment Sequence No. 31
Name(s) shown on return Juan		Identifying number 355-55-5555
Description of activity (see page 2 of the instructions) S Corporation Schedule K-1		
Part I Current Year Profit (Loss) From the Activity, Including Prior Year Nondeductible Amounts. See page 2 of the instructions.		
1 Ordinary income (loss) from the activity (see page 2 of the instructions)	1	(18,500)
2 Gain (loss) from the sale or other disposition of assets used in the activity (or of your interest in the activity) that you are reporting on:		
a Schedule D	2a	
b Form 4797	2b	
c Other form or schedule	2c	
3 Other income and gains from the activity, from Schedule K-1 of Form 1065, Form 1065-B, or Form 1120S, that were not included on lines 1 through 2c	3	
4 Other deductions and losses from the activity, including investment interest expense allowed from Form 4952, that were not included on lines 1 through 2c	4	(1,500)
5 Current year profit (loss) from the activity. Combine lines 1 through 4. See page 3 of the instructions before completing the rest of this form	5	(20,000)
Part II Simplified Computation of Amount At Risk. See page 3 of the instructions before completing this part.		
6 Adjusted basis (as defined in section 1011) in the activity (or in your interest in the activity) on the first day of the tax year. Do not enter less than zero	6	
7 Increases for the tax year (see page 3 of the instructions)	7	10,000
8 Add lines 6 and 7	8	
9 Decreases for the tax year (see page 4 of the instructions)	9	10,000
10a Subtract line 9 from line 8 ▶ 10a 10,000		
b If line 10a is more than zero, enter that amount here and go to line 20 (or complete Part III). Otherwise, enter -0- and see Pub. 925 for information on the recapture rules	10b	10,000
Part III Detailed Computation of Amount At Risk. If you completed Part III of Form 6198 for the prior year, see page 4 of the instructions.		
11 Investment in the activity (or in your interest in the activity) at the effective date. Do not enter less than zero	11	
12 Increases at effective date	12	
13 Add lines 11 and 12	13	
14 Decreases at effective date	14	
15 Amount at risk (check box that applies):		
a <input type="checkbox"/> At effective date. Subtract line 14 from line 13. Do not enter less than zero.		
b <input type="checkbox"/> From your prior year Form 6198, line 19b. Do not enter the amount from line 10b of your prior year form.	15	
16 Increases since (check box that applies):		
a <input type="checkbox"/> Effective date b <input type="checkbox"/> The end of your prior year	16	
17 Add lines 15 and 16	17	
18 Decreases since (check box that applies):		
a <input type="checkbox"/> Effective date b <input type="checkbox"/> The end of your prior year	18	
19a Subtract line 18 from line 17 ▶ 19a		
b If line 19a is more than zero, enter that amount here and go to line 20. Otherwise, enter -0- and see Pub. 925 for information on the recapture rules	19b	
Part IV Deductible Loss		
20 Amount at risk. Enter the larger of line 10b or line 19b	20	10,000
21 Deductible loss. Enter the smaller of the line 5 loss (treated as a positive number) or line 20. See page 8 of the instructions to find out how to report any deductible loss and any carryover	21	(10,000)
Note: If the loss is from a passive activity, see the Instructions for Form 8582 , <i>Passive Activity Loss Limitations</i> , or the Instructions for Form 8810 , <i>Corporate Passive Activity Loss and Credit Limitations</i> , to find out if the loss is allowed under the passive activity rules. If only part of the loss is subject to the passive activity loss rules, report only that part on Form 8582 or Form 8810, whichever applies.		

For Paperwork Reduction Act Notice, see page 8 of the instructions.

Cat. No. 50012Y

Form **6198** (Rev. 11-2009)

At-Risk Recapture

If a shareholder's at-risk amount decreases during the tax year, a portion of the losses previously allowed must be recaptured. This is accomplished by increasing the year's income from the S corporation by the lesser of:

- The negative at-risk amount (expressed as a positive income amount), or
- The total amount of losses deducted in previous tax years minus any amounts previously added to income under this recapture rule.

The recapture amount that must be recognized in the tax year is not used to offset a net loss that exists from the activity for that year. However, the recaptured amount can be deducted from the income from that activity in a subsequent year.⁷¹

At-Risk Aggregation Rules

When one business entity engages in more than one type of business activity, special rules determine which activities must be looked at separately and when they can be aggregated.

Generally, activities involving film or video tape, leased personal property (IRC §1245), farming, oil and gas property, and geothermal property must be treated separately.⁷² Therefore, the at-risk rules apply separately to each film, each item of leased property, and each farming activity. However, the following **exceptions** to this general rule apply to S corporations.

- All activity involving the leasing of personal property must be aggregated into one single activity.⁷³
- All at-risk activities constituting a trade or business can be aggregated into one activity if the taxpayer actively participates in the management of the business or at least 65% of the losses for the tax year are allocable to persons who actively participate in the management of the business.⁷⁴

Active participation is defined differently than material participation. Indicators of **active participation** include when the shareholder:

- Makes operational or management decisions for the business,
- Performs services for the business, and
- Makes hiring and firing decisions for the business.

Conversely, a lack of control or management, authority to discharge only a top manager, and using independent contractors rather than employees denotes a lack of active participation.⁷⁵

⁷¹ IRC §465(e)(1)(B).

⁷² IRC §465(c)(2)(A).

⁷³ IRC §§465(c)(2)(B) and (c)(2)(B)(i).

⁷⁴ IRC §465(c)(3)(B).

⁷⁵ This guidance comes from the 1976 Committee Report drafted when IRC §465 was enacted.

PASSIVE ACTIVITY LOSS RULES

Note. For more information about material participation, grouping, and other passive activity rules, see the 2014 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: Passive Activities. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

The third hurdle that an S corporation shareholder must overcome to deduct losses passed through from the corporation is presented by the passive activity loss (PAL) rules. As with the general basis rules and the at-risk rules, the shareholder's ability to deduct a loss may be limited by the PAL rules.⁷⁶

As an initial rule, when the shareholder does **not** materially participate in the S corporation's business⁷⁷ or if the S corporation is in the business of real estate rental,⁷⁸ the PAL rules apply.

Material participation is generally defined as regular, continuous, and substantial involvement in the operations of the business activity by the shareholder.⁷⁹ However, the shareholder is considered to materially participate if **any** of the following apply during the year.⁸⁰

1. The shareholder participates in the activity for more than 500 hours.
2. The shareholder's participation in the activity constitutes substantially all the participation in the activity by all individuals (including nonshareholders).
3. The shareholder participates in the activity for more than 100 hours, and no other individual participates in the activity more than the shareholder.
4. The activity is a significant participation activity, and the shareholder's aggregate participation in all significant participation activities exceeds 500 hours.
5. The shareholder materially participated in the activity for any five of the preceding 10 tax years (not necessarily consecutive).
6. The activity is a personal service activity,⁸¹ and the shareholder materially participated in any three preceding tax years (not necessarily consecutive).
7. Based on the facts and circumstances, the shareholder participates on a regular, continuous, and substantial basis.

When the shareholder does not materially participate in the business activity, the resulting business loss from that activity is categorized as a PAL. The shareholder cannot deduct the PAL against other active income. Instead, the PAL carries forward to subsequent years indefinitely until it can be used against passive activity income. Losses carried forward can be used when the shareholder's interest in the passive activity is sold.

Caution. In connection with a shareholder's state tax situation, it should be noted that a passive loss arising from activity in one state may not be useful in providing a current year or future year deduction against passive income sourced from another state.

⁷⁶ IRC §469(a).

⁷⁷ IRC §469(c)(1)(B).

⁷⁸ IRC §469(c)(2).

⁷⁹ IRC §469(h)(1).

⁸⁰ Temp. Treas. Reg. §1.469-5T(a).

⁸¹ Defined in Temp. Treas. Reg. §1.469-5T(d).

The general rule classifying real estate rental as passive is accompanied by two ancillary rules relating to real estate. First, real estate activity is not classified as passive income when the S corporation shareholder is a **real estate professional**.⁸² Second, even when the real estate rental is considered passive, taxpayers may be allowed to **deduct up to \$25,000** of rental losses against other active income if they actively participated in the real estate activity.⁸³ However, this amount is reduced if the taxpayer's adjusted gross income exceeds \$100,000. Different rules apply to married taxpayers filing separate returns.⁸⁴ Unused rental losses carry forward to future years.

Activities that are sufficiently related may be grouped so that a taxpayer meets the participation requirements for the grouped activities even if the participation requirements are not met for any particular activity by itself.

TERMINATION OF SHAREHOLDER'S INTEREST

GENERAL TAX RULES

Gain or loss is recognized on the sale of S corporation shares just as with other investments. **Realized capital gain** is the amount by which the proceeds received exceed the shareholder's basis. If there is a loss, the **realized capital loss** is the amount of basis in excess of the proceeds received. Consequently, proper determination of the selling shareholder's basis is critical in determining the amount of realized gain or loss.

A corporation may distribute real or personal property to a shareholder in termination of their interest in the S corporation. In this situation, the shareholder uses the FMV of the property as the sale price of the shares. If the FMV of the property is less than the shareholder's stock basis, the shareholder may recognize a loss — but only if the transaction comprises a complete termination of the shareholder's interest in the corporation.⁸⁵

The shareholder's ownership interest represented by the shares in the corporation that are sold must be **legitimately terminated** before the disposition is treated as a sale for tax purposes.

Note. For more information about the disposition of property distributed to shareholders, see the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: S Corporation Entity Issues.

Note. S corporation shares do not qualify for the exclusion of gain from certain small business stock under IRC §1202. Only shares of certain C corporations qualify for this exemption.

INSTALLMENT METHOD

The sale of a shareholder's S corporation stock may be structured as an installment sale. For the transaction to qualify under the installment-sale rules, at least one payment from the buyer must be received after the close of the tax year in which the sale took place.⁸⁶ Furthermore, the installment-sale method cannot be used when the sale of the stock results in a loss.

Note. Generally, the installment-sale rules must be used when the transaction is a properly structured installment sale. However, the seller can opt out by simply reporting gain from the entire transaction on the tax return for the year of the sale.⁸⁷

⁸² IRC §469(c)(7).

⁸³ IRC §469(i).

⁸⁴ IRC §469(i)(5).

⁸⁵ IRC §§302(a) and (b)(3).

⁸⁶ IRC §453(b)(1).

⁸⁷ IRC §453(d).

To qualify under the installment-sale rules, the note receivable cannot be payable on demand.⁸⁸ In addition, the note must be structured so that the seller receives at least one payment in the year following the year of the sale transaction. The use of a note or debt instrument that is readily tradable by the seller does **not** constitute qualifying debt for purposes of the installment-sale rules.⁸⁹

The installment-sale rules require the seller to report interest income each year in addition to any required gain amount. If the interest rate is less than the applicable federal rate (AFR) at the time of the sale for similar debt, interest must be imputed.

Note. AFRs are published each month in the Internal Revenue Bulletin. See IRS Pub. 537, *Installment Sales*, for more information.

If the former S corporation shareholder subsequently sells the installment obligation, any remaining gain that has not already been recognized is taxable in the year the note is sold.⁹⁰

BAD DEBTS

Any loan basis on unpaid loans that remain after an S corporation has terminated can be deducted as a bad debt by the shareholder. The form the shareholder uses to deduct this amount depends on the reason for the loan.

Most uncollectible debts from shareholder loans to S corporations are **nonbusiness bad debts**, which are deducted on Form 8949 with box C checked (“short-term transactions not reported on Form 1099-B”). These bad debts qualify as short-term capital losses⁹¹ and are subject to the \$3,000 per year capital loss limitation.⁹²

Note. Although some taxpayers have argued that a shareholder loan to an S corporation is business debt because it originated from loaning money to the business they owned, in this context, **nonbusiness** bad debt means that the debt did not arise from being in the business of making loans.

If the loan is made as part of the shareholder’s “**business of being an employee**” and a valid business reason for the loan can be shown, then the bad debt is an employee business expense. As such, it is deductible on Form 2106, and carried to Schedule A as a miscellaneous itemized deduction subject to the 2%-of-AGI threshold. Although this is typically not the ideal treatment, it results in 100% of the remaining basis of the bad debt being deductible in the year that the debt is deemed uncollectible.

*Litwin v. U.S.*⁹³ demonstrates a fact pattern that supports the treatment of bad debt as an employee business expense when the loans are to a corporation in which the taxpayer has an ownership investment. In this case, the taxpayer had a history of starting corporations, hiring himself, making a significant amount of money, and selling the corporation at a profit.

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

⁸⁸ IRC §453(f)(4)(A).

⁸⁹ IRC §453(f)(4)(B).

⁹⁰ IRC §453B.

⁹¹ IRC §166(d)(1)(B).

⁹² Treas. Reg. §1.166-5(a)(2).

⁹³ *Litwin v. U.S.*, 983 F.2d 997 (10th Cir. 1993).

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 his salary. He felt he could not get other jobs due to his “advanced age.” Additionally, he contended the \$300,000 was reasonable compared to his salary (which was nearly \$100,000). The court allowed the deduction, stating 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.

Observations. The two factors that significantly benefited Mr. Litwin’s claim in this case were the amount of time he devoted to the business and the amount of debt risk he assumed compared to the value of his investment. In most situations, the bases in loans from a 100% shareholder in an S corporation will most likely be near zero from the deduction of loss items that were paid by the loans. However, a shareholder-employee who made loans to an S corporation that were disproportionate to their ownership percentage may still have sufficient basis in the loans to make this treatment defensible and worthwhile.

Note. Deducting a bad debt on Schedule A could have a number of interesting tax consequences. It could create a net operating loss if it is large enough. It also could trigger AMT because a taxpayer’s miscellaneous itemized deductions subject to the 2% threshold are added back for AMT calculation purposes.

If the loan was made from another business operated by the shareholder, the loan may be a **business bad debt**. One example is a taxpayer who owns a sole proprietorship providing construction services that does business with an S corporation that the taxpayer owns stock in. If the taxpayer made a loan to the S corporation to preserve the business relationship, the loan will be business bad debt. In this case, the basis of the loan is deductible on the Schedule C, *Profit or Loss From Business*, on which the business activity is reported.

IRC §1244 STOCK LOSSES

IRC §1244 allows stockholders to deduct 100% of the losses on certain stock as **ordinary losses** up to \$50,000 (\$100,000 for married taxpayers filing jointly.) A disposition of the entire interest in an S corporation might qualify if the stock meets all the Code provisions. In particular, **only the original contribution made in exchange for the stock is eligible for the §1244 treatment**.

Any additional contribution to the capital of the S corporation does not qualify for §1244 treatment **unless** new shares are issued in exchange for the new contribution. Furthermore, any additional stock basis, such as income and 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 capital loss treatment based on the investments.

Example 29. In 2015, Devon Millikens invested \$50,000 in Bulldog Corporation (Bulldog), an S corporation. His 2015 Schedule K-1 showed a \$30,000 profit. This increased his basis to \$80,000. Devon’s 2016 Schedule K-1 showed no income or loss. In 2016, Bulldog liquidated and Devon received \$20,000 in complete liquidation of his investment.

Devon’s basis in his S corporation stock is \$80,000. His loss is \$60,000 (\$80,000 – \$20,000).

Devon’s original investment of \$50,000 qualifies for §1244 treatment. His §1244 loss is \$37,500 $((\$50,000 \text{ investment} \div \$80,000 \text{ basis}) \times \$60,000 \text{ loss})$. This portion of the loss is reported on Form 4797. The remaining \$22,500 of loss $(\$60,000 - \$37,500)$ is reported on Form 8949 with box C checked (“short-term transactions not reported on Form 1099-B”).

Note. Neither the Code nor other IRS guidance appears 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 the tax practitioner takes the position that income and losses that occur after the original contribution are netted and that the original contribution is the remaining portion (up to the original contribution amount), they may want to advise their client in writing that the IRS may take a different position.

SUSPENDED PASSIVE ACTIVITY LOSSES

Provided there is sufficient basis, when shareholders dispose of their **entire** interest in an S corporation, any losses suspended because of the passive activity rules are generally released in that year.⁹⁴ To qualify, the disposition must be made in a fully taxable event to an unrelated party. If shareholders continue to hold debt payable from the corporation after disposition of their stock, the stock disposition is still considered a disposition of their entire investment for passive loss purposes.

In certain situations, the taxpayer can deduct a portion of the suspended passive losses when a disposition does not qualify as a complete disposition.⁹⁵ The disposition must be of **substantially all** the passive activity. In addition, the taxpayer must be able to establish with reasonable certainty both of the following.

1. The amount of the suspended deductions and credits allocable to the disposed portion of the activity
2. The amount of gross income and any other deductions and credits allocable to that part of the activity for the current tax year

LOSSES CARRIED FORWARD UNDER BASIS LIMITATIONS

Any losses carried forward due to basis limitations are still subject to basis limitations in the final year of the shareholder's involvement with the S corporation. There are no provisions in the Code or regulations allowing the basis rules to be disregarded in the event of liquidation of the shareholder's interest.

⁹⁴ IRC §469(g).

⁹⁵ Treas. Reg. §1.469-4(g).