Chapter 10: Small Business Issues

Note. Corrections were made to this workbook through January of 2024. No subsequent modifications were made. For terms used in this chapter, see the **Acronyms and Abbreviations** section following 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.

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PLANNING AND PITFALLS OF PASS-THROUGH ENTITY TAX

Among the many changes arising from the passage of the Tax Cuts and Jobs Act (TCJA)[1], taxpayers are subject to a limitation on the deductibility of itemized state and local taxes (SALT) of $10,000 ($5,000 if taxpayers are married filing a separate return).[2] Per IRC §164, taxpayers are generally allowed a deduction for certain taxes paid or accrued for the following taxes.

- State, local, and foreign real property taxes
- State and local personal property taxes
- State, local, and foreign income, war profits, and excess profits taxes

The SALT limitation is effective for tax years beginning after December 31, 2017, and before January 1, 2026.[3]

Some states implemented pass-through entity (PTE) tax legislation to allow a method to avoid the SALT limitation. These taxes shift the state income tax to the PTE and away from the PTE's owners. In this context, PTEs include partnerships and S corporations.[4]

> **Note.** Although the rules for PTE taxes apply to both shareholders in an S corporation and partners in a partnership, this section will use the term "shareholder" to encompass both groups of individuals.

Mechanically, the concept of PTE taxes works as an election a PTE makes on its state income tax return. Once a PTE makes this election, the state PTE tax is deductible as an expense on the entity's federal income tax return. When the PTE issues Schedule K-1 (1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.*, or Schedule K-1 (1065), *Partner's Share of Income, Deductions, Credits, etc.,* to each shareholder, the Schedule K-1 reflects an additional deduction of the PTE tax paid by the entity. As a result, this deduction reduces the taxpayer's federal adjusted gross income (AGI), instead of producing a possible itemized state income tax deduction. [5]

> **Note.** The IRS issued Notice 2020-75[6] in 2020, stating that it intended to issue proposed regulations on PTE tax issues. However, in the three years since that notice was issued, there still are not any proposed regulations. This forces tax practitioners into the unenviable situation of having to take positions without substantial authority. The notice is not substantial authority, but it can be relied upon.

Because the PTE tax is a state income tax, the process, treatment, and allowability of the tax differ from state to state. This section contains an overview of the different state treatments of the PTE tax, a discussion of the benefits and costs of electing a PTE tax, and some planning considerations associated with the PTE tax.

PTE TAX APPROACH BY STATE

While each state has its own application and processes regarding the PTE tax, there are some similarities among state treatments. This section identifies the different types of treatments and which states have adopted them. The appendix to this chapter contains a list of states with PTE tax elections and associated tax rates.

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1. *Tax Cuts and Jobs Act,* PL 115-97, §11042.
2. IRC §164(b)(6)(B).
3. *Tax Cuts and Jobs Act,* PL 115-97, §11042; IRC §164.
4. IRS Notice 2020-75, 2020-49 IRB 1453.
5. Ibid.
6. Ibid.

Requirement of Estimated Tax Payments

Most states require entities making the PTE tax election to pay the tax in estimated quarterly payments to avoid underpayment penalties. Using **Illinois** as an example, PTEs making the PTE tax election must pay estimated tax payments when the expected total tax due exceeds $500 or the PTE will incur late estimated payment penalties.[7] PTE estimated tax payments for most states are due by the 15th day of the 4th, 6th, 9th, and 12th month of the tax year. However, practitioners and taxpayers should be mindful of specific state due dates. For example, **Connecticut's** 4th quarter payment is due by the 15th day of the 1st month of the subsequent tax year.[8] These due dates are critical to avoid penalties, as PTEs must make the PTE estimated payments for the year they are seeking the PTE tax election in that tax year.

Practitioner Planning Tip

It is important to have the conversation about the PTE tax election early in the year with clients. This allows the taxpayer to make all the necessary estimated payments during the year.

PTEs make estimated tax payments periodically through the tax year and reconcile them with the amount of PTE tax they calculate after the tax year ends when preparing and filing their state tax returns. Most states have a safe harbor for estimated tax payments to avoid underpayment tax penalties. For example, **Illinois** PTEs must pay at least 90% of the filing tax year's liability or 100% of the preceding tax year's liability to avoid late payment penalties.[9]

Example 1. Veridian Innovations (Veridian) is an S corporation located in Illinois with a calendar yearend and uses the cash basis of accounting. In March 2022, the company's tax advisor, Monica, suggested making the PTE tax election for Illinois in 2022 after discovering all three shareholders could not deduct their total state income tax on their federal returns due to the SALT limitation. Veridian's state tax liability for 2021 was $7,000. Per Monica's instructions, Veridian paid estimated tax payments of $1,750 per quarter ($7,000 ÷ 4) to satisfy Illinois's estimated tax payment safe harbor (100% of the prior year tax liability of $7,000) to avoid underpayment penalties. Because Monica identified the benefit of the PTE tax election early in the year and communicated her suggestion to Veridian promptly, Veridian was able to pay the 1st quarter's $1,750 estimated tax payment by the April 15th deadline.

Note. If all Veridian shareholders were in the 22% federal tax bracket, excluding the qualified business income deduction, the potential PTE benefit is $1,540 ($7,000 × 22%).

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7. 35 ILCS 5/201(p)(9).

8. *Pass-Through Entity Tax Information*. 2023. Connecticut State Department of Revenue Services. [portal.ct.gov/DRS/Taxes/Pass-Through-Entity/Tax-Information#estimated] Accessed on Jun. 29, 2023.

9. IDOR Pub. 129, *Pass-through Entity Information*.

Generally, electing PTEs that overpay the PTE tax receive a refund of the overpayment when preparing the state income tax return. Some states do not allow PTEs to apply the overpayment to the following tax year's estimated PTE tax payments.[10] Other states, such as **Illinois**, allow PTEs to apply the overpayment as a credit for the following tax year.[11] Regardless of the treatment of the overpayment, the amount of PTE tax on a shareholder's state Schedule K-1 reflects their share of the tax that the entity **elects,** not the amount of estimates that the entity made throughout the year. Therefore, the shareholder does not receive credit for an overpayment applied to a future tax return on their state Schedule K-1 for the current tax year.[12]

Annual Liability Payment

Not all states require PTEs to make estimated PTE tax payments. For example, **Missouri** does not require a PTE to make estimated tax payments regardless of the tax liability, where the PTE pays the liability by the 15th day of the 4th month after the PTE's yearend.[13] Some states, like **Missouri**, allow PTEs to make early payments via a voucher if they are so inclined.[14]

This may present an issue for PTEs using **cash basis accounting,**[15] where the PTE reports the PTE liability payment as an expense in the year it made the payment, as opposed to the tax year for which the payment was applicable.[16] The IRS proposed regulations clarifying such payments are deductible for the tax year the PTE made the payment.[17] Generally, **accrual-basis** taxpayers deduct the PTE payment in the year they make the payment, regardless of the tax year for which the payment is applied.[18] For example, a calendar-year, accrual-basis taxpayer that makes a 4th quarter estimate in January 2023 for the 2022 tax year could not deduct the 4th quarter payment for the 2022 tax year, rather deducting it on the 2023 tax return. The reasoning behind this treatment is attributable to the requirement of the liability being fixed and economic performance having occurred to deduct the accrued tax liability in 2022.[19] Because the election to have PTE tax be entity-based occurs when filing the income tax return after yearend, which proceeds the year for which the election is made, accrual-basis taxpayers do not meet the requirement of economic performance. Therefore, they cannot accrue the 4th quarter estimate as a deduction on the 2022 return.

10. *Help with pass-through entity elective tax*. Jun. 7, 2023. State of California Franchise Tax Board. [www.ftb.ca.gov/file/business/credits/pass-through-entity-elective-tax/help.html] Accessed on Jul. 5, 2023.

11. 2022 Instructions for IL-1120-ST.

12. IDOR Pub. 129, *Pass-through Entity Information*.

13. *Pass-Through Entity Tax FAQs*. 2023. Missouri Department of Revenue. [dor.mo.gov/faq/taxation/business/entity-tax.html] Accessed on Jul. 5, 2023.

14. Ibid.

15. IRC §446.

16. See Treas. Reg. §1.461-4(g)(6).

17. IRS Notice 2020-75, 2020-49 CB 1453.

18. See Treas. Reg. §1.461-4(g)(6).

19. Treas. Reg. §1.461-4.

Recurring Item Exception. There is an exception under Treas. Reg. §1.461-5 that accrual taxpayers may use to deduct an accrued tax payment in the year preceding the year in which the amount is paid known as the **recurring item exception.** This exception is a change in accounting method, where a taxpayer automatically adopts the method in treating a specific, recurring item in the 1st year the taxpayer incurs the item.[20] A taxpayer may implement this exception if the following criteria apply to the accrued item.[21]

1. At the end of the year, all events have occurred in establishing the liability, **and** the taxpayer can accurately determine its amount.
2. The taxpayer achieves **economic performance** on or before the 15th day of the 9th month following the tax yearend **or** the date that the taxpayer timely files their return (including extensions), whichever is earlier. Economic performance for tax payments occurs as the taxpayer **pays the tax** to the governmental authority.[22]
3. The liability is a recurring item, where the taxpayer expects to incur the liability from one tax year to the next, even if the taxpayer does not incur the liability in each tax year.
4. The liability is not material, **or** the accrued liability best matches the related income for the tax year that the taxpayer achieves economic performance. Materiality depends on the amount of the liability relating to the same activity's other income and expenses and includes, but is not limited to, materiality thresholds under generally accepted accounting principles (GAAP). For determining the matching requirement, GAAP may help substantiate the relationship, but it is not absolute.

> **Caution.** Practitioners should note that authoritative guidance does not explicitly state that the recurring item exception may apply to PTE tax payments. While Treas. Reg. §1.461-4 states that taxpayers, if meeting the criteria, may use the exception for liabilities to pay a tax, it is silent as to which specific taxes apply. This omission contrasts with the regulations identifying the tax payments for which the general rules apply earlier in the same section.[23] Therefore, taxpayers should exercise caution if advising their accrual-basis clients making PTE tax payments to elect this accounting change for the exception.

PTE Tax Return

For some states, PTEs can make the PTE tax election on the state's tax return for partnerships and S corporations. For example, **Illinois** has a checkbox on page 1, line L of the IL-1120-ST, *Small Business Corporation Replacement Tax Return*, as shown next.

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> **Note.** Illinois partnerships and S corporations are subject to a replacement tax of 1.5% on entity income; this is treated like income tax.

20. Treas. Reg. §1.461-5(b)(1).
21. Treas. Reg. §1.461-5(b).
22. Treas. Reg. §1.461-4(g)(6).
23. Ibid.

Illinois Department of Revenue

2022 Form IL-1120-ST

Small Business Corporation Replacement Tax Return

Due on or before the 15th day of the 3rd month following the close of the tax year.

If this return is not for calendar year 2022, enter your fiscal tax year here.
Tax year beginning ____ ____ 20____, ending ____ ____ 20____
month day year month day year

WARNING This form is for tax years ending on or after December 31, 2022, and before December 31, 2023. For all other situations, see instructions to determine the correct form to use.

Enter the amount you are paying. $____

Step 1: Identify your small business corporation

A Enter your complete legal business name.
If you have a name change, check this box. ☐
Name: ____

B Enter your mailing address.
Check this box if either of the following apply: ☐
- this is your **first return**, or
- you have an **address change**.

C/O: ____
Mailing address: ____
City: ____ State: ____ ZIP: ____

C If this is the first or final return, check the applicable box(es).
☐ First return
☐ Final return (Enter the date of termination. ___ ___ ______)
mm dd yyyy

D If this is a final return because you sold this business, enter the date sold (mm dd yyyy) ___ ___ ______ , and the new owner's FEIN ___ ___ - ___ ___ ___ ___ ___ ___ ___.

E **Apportionment Formulas**. Check the appropriate box or boxes and see the Apportionment Formula instructions.
☐ Financial organizations ☐ Transportation companies
☐ Federally regulated exchanges ☐ Sales companies

F Check this box if you attached Form IL-4562. ☐
G Check this box if you attached Illinois Schedule M (for businesses). ☐
H Check this box if you attached Schedule 80/20. ☐
I Check this box if you attached Schedule 1299-A. ☐
J Check this box if you attached the Subgroup Schedule. ☐
K Check this box if you are a 52/53 week filer. ☐
L Check this box if you elected to file and pay Pass-through Entity Tax. See instructions. ☒
M If you are paying Pass-through Entity Tax and you annualized your income on Form IL-2220, check this box and **attach** Form IL-2220. ☐

N Enter your federal employer identification number (FEIN).
___ ___ - ___ ___ ___ ___ ___ ___ ___

O ☐ Check this box if you are a member of a unitary business group and enter the FEIN of the member who prepared the Schedule UB, Combined Apportionment for Unitary Business Group. **Attach** Schedule UB to this return.
___ ___ - ___ ___ ___ ___ ___ ___ ___

P Enter your North American Industry Classification System (NAICS) Code. See instructions.
___ ___ ___ ___ ___ ___

Q Enter your Illinois corporate file (charter) number issued by the Secretary of State.
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R Enter the city, state, and zip code where your accounting records are kept. (Use the two-letter postal abbreviation, *e.g.*, IL, GA, etc.)
City ____ State ____ ZIP ____

S If you are making the business income election to treat all nonbusiness income as business income, check this box and enter zero on Lines 36 and 44. ☐

T If you have completed the following, check the box and **attach** the federal form(s) to this return.
☐ Federal Form 8886 ☐ Federal Sch. M-3, Part II, Line 10

U If you are making a discharge of indebtedness adjustment on Schedule NLD or Form IL-1120-ST, Line 48, check this box and **attach** federal Form 982. ☐

V Check this box if your business activity is protected under Public Law 86-272. ☐

However, other states have a unique tax return specifically for PTEs making the election. Using **Arkansas** as an example, a PTE making the election files Form AR1100PET, *Arkansas Pass-Through Entity Tax Return*, instead of Form AR1100S, *Arkansas S Corporation Income Tax Return*, or Form AR1050, *Arkansas Partnership Income Tax Return*. Alternatively, a PTE files Form AR1100S or AR1050 and includes Form AR362, *Arkansas Pass-Through Entity Income Tax Election Or Revocation Form*, to make a valid PTE tax election. Arkansas treats the PTE tax election as valid for each tax year until the PTE revokes it. Therefore, if a PTE decides to revoke the election for a given tax year, they must file Form AR362 with Form AR1100S or AR1050 for the tax year they are seeking revocation.[24]

[24] Instructions for Form AR362.

Mandatory PTE Tax Treatment[25]

Connecticut is the only state to **require** PTEs doing business and filing in the state to adopt the PTE tax. PTEs doing business in Connecticut use the same tax form as in prior years to report income tax: Form CT-1065/CT-1120SI, *Connecticut Pass-Through Entity Tax Return*. The difference in procedure consists of the state assessing tax at the entity level instead of passing through to shareholders for taxation at their level. Connecticut does require quarterly estimated tax payments for PTEs with tax liabilities equaling or exceeding $1,000.

BENEFITS VS. COSTS OF THE ELECTION

The purpose of the PTE tax election is to allow taxpayers to deduct state income taxes that they may have otherwise not been able to deduct due to the SALT limitations. PTEs must consider the costs and hurdles associated with the election and weigh them against the tax benefits. In doing so, PTEs will be better equipped to decide whether to proceed with this potential tax-saving option. Because each state is different and does not conform to a unifying set of policies, procedures, and treatments, PTEs should consider the following issues to help them assess whether to elect PTE tax treatment for a given state.

Treatment of Out-of-State Income

One of the most complex areas practitioners face is multistate taxation. Unsurprisingly, PTEs with income in multiple states have additional complexity when assessing whether to make the PTE tax election. Most of this consideration revolves around how states treat out-of-state income. Some states use apportionment to differentiate between in-state and out-of-state income, where an entity determines the sourcing of its income based on property, payroll, sales, or a combination of the three. The method of determining income sourcing and how each state treats out-of-state income regarding PTE tax is a key consideration in estimating and calculating PTE tax under the election.

Some states calculate the PTE tax on income after apportioning global income to the state. For example, **Illinois** applies an apportionment percentage that results from dividing Illinois sales by global sales. This percentage is applied to the PTE's net business income to arrive at the amount of Illinois taxable pass-through income. Finally, this taxable pass-through income is multiplied by the state income tax rate to arrive at the amount of PTE tax. The PTE will pay this PTE tax in addition to the state replacement tax, and the shareholders will receive an Illinois tax credit for their share of the paid PTE tax (excludes the replacement tax). Through this methodology, the calculation of PTE tax is after the apportionment of Illinois income, resulting in a tax on the income sourced to Illinois based on a sales apportionment factor.[26]

Treatment of Nonbusiness Income

Some states use an allocation model in determining the taxability of nonbusiness income comprising investment and other passive activities. This method generally entails the allocation of nonbusiness income to a taxpayer's state of domicile or where the property resides.

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25. *Pass-Through Entity Tax Information*. 2023. Connecticut State Department of Revenue Services. [portal.ct.gov/DRS/Taxes/Pass-Through-Entity/Tax-Information#whomustfile] Accessed on Jul. 5, 2023.

26. Form IL-1120-ST.

The PTE tax election and nonbusiness income revolves around the **source of the income.** States may differ on the treatment of nonbusiness income sourcing and a potential result is a portion of income may not have a source. This concept is often referred to as **"nowhere income."**[27] While this treatment may sometimes work favorably for the taxpayer where they do not pay any state tax on "nowhere income," some states have addressed this issue by imposing a throwback rule requiring taxpayers to include the "nowhere income" as taxable income to the state.[28] Thus, there may be instances where a taxpayer is taxed on the same income in multiple states. The PTE tax generally follows the state's treatment of nonbusiness income, where the election does not alter the treatment of nonbusiness income.[29] However, most states offering the PTE tax election assess the PTE tax at the highest personal income tax rate.[30] Considering this fact, double income taxation may result in a more unfavorable position than not making the PTE tax election. As such, PTEs with nonbusiness income should assess the states in which they have filing requirements and identify the respective states' treatment of nonbusiness income.

Source of Refunds

Generally, the overpayment of PTE tax results in a refund receivable by the PTE as opposed to shareholders directly. For example, if a PTE overpaid its **Illinois** PTE tax, the PTE would reflect the overpayment on the Illinois tax return and request a refund or apply it to next year's estimated tax. Because shareholders should only receive a state credit for the tax paid, the amount of the refund would reduce their credit by their ownership share.[31]

Example 2. Assume the same facts as **Example 1.** At the end of the year, Veridian's tax liability is $7,785, consisting of $1,845 replacement tax and $5,940 PTE tax. Therefore, Veridian records an underpayment of $785 ($7,785 total tax liability – $7,000 PTE estimated payments). While Veridian owes tax for 2022, Veridian in fact overpaid its PTE tax by $1,060 ($7,000 PTE estimated payments – $5,940 actual PTE tax), with the excess applied to the $1,845 replacement tax. Even though Veridian paid estimates of more than the $5,940 of PTE tax, Veridian's shareholders only collectively receive credit for the $5,940 of PTE tax. The balance is used to pay the replacement tax. Veridian's chief executive officer (CEO), Isaac Evers, who owns 50% shares in the company, receives a PTE tax credit of $2,970 ($5,940 × 50%) on his Illinois Schedule K-1-P, *Partner's or Shareholder's Share of Income, Deductions, Credits, and Recapture*.

Treatment of Out-Of-State Owners

The PTE tax election is entity-based in most states, where the electing PTE pays PTE tax on behalf of all its shareholders, regardless of their residency. Therefore, nonresidents of a state where a PTE elects the PTE tax will receive a state Schedule K-1 showing their share of the state income and the PTE tax credit. States have provided guidance and clarification stating the PTE election alone does not create a filing requirement for nonresidents in the state.[32] For most states, such as **Alabama,** if the nonresident shareholder would not otherwise be required to file a tax return in the state due to the source and amount of taxable income, then the shareholder is not obligated to file a tax return in the state.[33] Furthermore, some states, such as **Illinois,** have clarified that if the PTE tax credit satisfies the nonresident shareholder's state income tax liability, they need not file a tax return in the state.[34]

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27. *Does Your State Have a Throwback or Throwout Rule?* Fritts, Janelle. Apr. 4, 2023. Tax Foundation. [taxfoundation.org/state-throwback-rule-state-throwout-rule-2023] Accessed on Jul. 28, 2023.

28. Ibid.

29. See, for example, IDOR Pub. 129, *Pass-through Entity Information*.

30. *Links to States' Pass-Through Entity (PTE) Tax Legislation and Tax Authorities' Information and Guidance.* Jun. 13, 2023. AICPA. [us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-links-to-pass-through-entity-pte-taxes-states-legislation-and-tax-authorities-information-and-guidance.pdf] Accessed on Jul. 28, 2023.

31. IDOR Pub. 129, *Pass-through Entity Information*.

32. *Pass-Through Entity-Level Tax: Frequently Asked Questions*. May 5, 2023. Arkansas Department of Finance and Administration. [www.dfa.arkansas.gov/images/uploads/incomeTaxOffice/PET_TAX_FAQ_2023.pdf] Accessed on Jul. 28, 2023.

33. *FAQ for Electing Pass-Through Entities.* Jun. 30, 2022. Alabama Department of Revenue. [www.revenue.alabama.gov/individual-corporate/electing-pass-through-entities] Accessed on Jul. 5, 2023.

34. IDOR Pub. 129, *Pass-through Entity Information*.

The concept of a PTE tax credit alleviating a nonresident shareholder from a state filing requirement may sound familiar to multistate tax practitioners. This notion follows a similar framework to the concept of state composite tax returns. For states either allowing or requiring them, a PTE prepares and files a composite return on behalf of a consenting nonresident shareholder to report their share of state income tax and pay the corresponding tax liability on behalf of the shareholder.[35] The PTE treats the tax payment as a shareholder distribution and is not a deductible expense.[36] Therefore, a PTE tax election, which conceptually operates similarly, may prevent the need to file composite tax returns for nonresident shareholders. Some states conform to this reasoning, such as **Georgia,** where the PTE would not prepare a composite return if making the PTE tax election.[37] However, other states, such as **Oregon,** still require an entity to file composite tax returns on behalf of their nonresident shareholders when making the PTE tax election.[38] PTEs should be mindful of these filing requirements and how the PTE tax election creates any changes to these requirements.

Owner Approval Requirements

In the planning stages of assessing the benefits of making a PTE tax election, filers should consider the requirements surrounding owner approval of the election. This requirement may impact the feasibility of making the election if there are members who disagree on whether to do so in states that require unanimous or majority consent. The requirements for owner consent vary from state to state. **Arkansas** requires members collectively owning more than 50% of the PTE's voting rights to consent to make the election, but only requires one responsible party's signature indicating this consent.[39] Other states, such as **Illinois,** consider the election to be made by the entity, and does not require member signatures other than the signing party's signature for the tax return.[40]

Payment of Estimated Taxes

As discussed previously, states requiring PTEs to make estimated PTE tax payments generally require the 1st quarter payment by the 15th day of the 4th month following the PTE's yearend. This results in a relatively short period of time for a PTE to assess whether to plan on making a PTE tax election and pay the first installment on time to avoid late payment penalties. Therefore, PTEs should identify which states they are seeking the election for that require estimated tax payments and prioritize calculating and paying estimated taxes accordingly.

Revocability of Election

In some states, the PTE tax election is irrevocable for the tax year the PTE files the return making the election. For example, **New York** does not allow an amendment reversing the PTE tax election made on a filed tax return.[41] Taxpayers should be mindful of these states that generally consider the tax return filing event as making a valid election (i.e., making an estimated payment does not constitute making a valid election.) Other states, such as **Arkansas**, allow PTEs to revoke the election, usually by filing an amended return by an extended due date.[42] The flexibility of revocability may be a consideration for some PTEs whose tax situation changes from a necessitating or beneficial amendment.

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35. *Considerations for Filing Composite Tax Returns*. Oppe, Ami and Zidik Jr., Donald. 2023. AICPA. [www.thetaxadviser.com/issues/2014/mar/tpm-mar2014.html] Accessed on Jul. 28, 2023.

36. Ibid.

37. *HB 149 Pass-Through Entity Tax FAQ.* 2023. Georgia Department of Revenue. [dor.georgia.gov/hb-149-pass-through-entity-tax-faq] Accessed on Jul. 6, 2023.

38. *Pass-Through Entity Elective (PTE-E) Tax.* 2023. Oregon Department of Revenue. [www.oregon.gov/dor/programs/businesses/pages/pass-through-entity-elective-tax.aspx] Accessed on Jul. 6, 2023.

39. *Pass-Through Entity-Level Tax: Frequently Asked Questions*. May 5, 2023. Arkansas Department of Finance and Administration. [www.dfa.arkansas.gov/images/uploads/incomeTaxOffice/PET_TAX_FAQ_2023.pdf] Accessed on Jul. 5, 2023.

40. IDOR Pub. 129, *Pass-through Entity Information*.

41. NYS Department of Taxation and Finance Technical Memorandum TSB-M-21(1)C, (1)I, *Pass-Through Entity Tax*.

42. *Pass-Through Entity-Level Tax: Frequently Asked Questions*. May 5, 2023. Arkansas Department of Finance and Administration. [www.dfa.arkansas.gov/images/uploads/incomeTaxOffice/PET_TAX_FAQ_2023.pdf] Accessed on Jul. 5, 2023.

Summary

A non-exhaustive list summarizing benefits and costs of adopting the PTE tax follows. Some items were previously discussed and others are simply items for consideration.

Benefits:

- Reduces federal AGI
- Transfers the payment of shareholder state tax to the entity
- Replaces pass-through withholding for out-of-state shareholders
- Ability to deduct state income tax without having to itemize
- May allow more utilization of other SALT deductions
- Reduces self-employment (SE) tax on partnerships
- May eliminate the requirement for an out-of-state shareholder to file a nonresident state income tax return
- May reduce or eliminate alternative minimum tax (AMT)

Costs:

- Additional professional fees
- Complexity of preparation, particularly for multistate returns
- Election may not benefit all shareholders
- May prompt additional estimated payment requirements
- A shareholder may fail to include their allocated PTE on their individual return
- May impact other tax credits on a shareholder's individual return
- Reduces the company's financial statement income
- Reducing federal AGI may decrease other benefits
- Lowering business income will reduce qualified business income (QBI)

Practitioner Planning Tip

If a PTE is uncertain whether to elect the PTE tax, it may be beneficial for them to pay estimated PTE tax payments regardless. When the PTE ultimately files its return, it can make a more informed decision on whether to make the election after reviewing the entity and shareholder tax situations, without penalty. Practitioners should be mindful of the state's overpayment refund processes before advising this approach to ensure the PTE can receive the funds without issue.

Practitioner Planning Tip

PTE owners must be mindful of the time needed in adopting the PTE tax and also the time of the tax practitioner. Due to the complexity involved, it is not unreasonable for a practitioner to charge a premium for the time spent researching and implementing PTE tax treatment for a client. Practitioners should be upfront about this extra cost with their clients so that they may better weigh the costs associated with making the PTE tax election against the benefits.

THE FLOW OF REPORTING THE PTE TAX

The PTE tax election likely encompasses several tax return forms and schedules. The flow of the reporting and how it impacts the different returns is important in understanding the nuances and functionality of adopting the PTE tax election. This section illustrates some of the forms, reporting, and the flow-through nature of the PTE tax election using the example of an Illinois company and shareholder.

Example 3. Use the same facts as **Example 2.** Based on Monica's suggestion, Veridian decided to elect the PTE tax in Illinois for the 2022 tax year. Veridian is owned by three shareholders, with CEO Isaac Evers owning 50% of the company.

During 2022, Veridian earned $300,000 gross income from its business and $3,000 nonbusiness interest income that is allocable to Illinois. Veridian incurred $160,000 in salary expenses and $20,000 in payroll tax expenses. Therefore, Veridian earned $123,000 of net income in 2022 before state income taxes ($300,000 gross income + $3,000 nonbusiness interest income – $160,000 salary expense – $20,000 payroll tax expenses). Veridian paid its estimated PTE tax payments totaling $7,000 on time for each quarter.

In preparing Form IL-1120-ST, Veridian makes the PTE tax election by checking box L on Step 1. Veridian then calculates its Illinois 1.5% replacement tax on its $123,000 net income as $1,845 ($123,000 × 1.5%). Veridian multiplied the $123,000 of income by the Illinois PTE tax rate of 4.95% to calculate its PTE tax of $6,089. Therefore, Veridian's total Illinois tax liability is $7,934 ($1,845 replacement tax + $6,089 PTE tax). Because Veridian paid $7,000 of estimated PTE tax for 2022, Veridian's unpaid Illinois tax liability is $934 ($7,934 – $7,000). Veridian is not subject to underpayment of tax penalties because the $7,000 of estimated tax payments were 100% of the prior year's Illinois tax. The following table summarizes the total federal Schedule K-1 income.

Gross income	$300,000
Salaries	(160,000)
Payroll taxes	(20,000)
PTE tax payments	(7,000)
Ordinary income	$113,000
Nonbusiness income	3,000
Total Schedule K-1 income	$116,000

Veridian takes the information from the table and completes Form IL-1120-ST, shown on the following pages.

Veridian prepares Form IL-1120-ST, Schedule B, *Partners' or Shareholders' Information*, which summarizes shareholders' information. In addition to reporting the names and addresses of its shareholders, Veridian reports each shareholder's share of income and PTE tax credit. The PTE tax credit for the shareholders totals the $6,089 PTE tax that Veridian calculated on Form IL-1120-ST. The shareholders do not receive a tax credit for the replacement tax, which has historically been an entity-level tax. Accordingly, Veridian prepares Schedules K-1-P for each shareholder, distributing a copy to each of them to assist with the preparation of their individual state income tax returns.

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For Example 3

Illinois Department of Revenue

2022 Form IL-1120-ST

Small Business Corporation Replacement Tax Return

Due on or before the 15th day of the 3rd month following the close of the tax year.

If this return is not for calendar year 2022, enter your fiscal tax year here.
Tax year beginning ____ ____ 20____, ending ____ ____ 20____ (month day year, month day year)

WARNING This form is for tax years ending on or after December 31, 2022, and before December 31, 2023. For all other situations, see instructions to determine the correct form to use.

Enter the amount you are paying. $ 934.00

Step 1: Identify your small business corporation

A Enter your complete legal business name. If you have a name change, check this box. ☐
Name: Veridian Innovations

B Enter your mailing address. Check this box if either of the following apply: ☐
- this is your **first return**, or
- you have an **address change**.

C/O: ____
Mailing address: 2002 Warner Ave.
City: Champaign State: IL ZIP: 61822

C If this is the first or final return, check the applicable box(es).
☐ First return
☐ Final return (Enter the date of termination. ___ ___ ___) mm dd yyyy

D If this is a final return because you sold this business, enter the date sold (mm dd yyyy) ___ ___ ___ , and the new owner's FEIN ___ ___ - ___ ___ ___ ___ ___ ___ ___.

E **Apportionment Formulas**. Check the appropriate box or boxes and see the Apportionment Formula instructions.
☐ Financial organizations ☐ Transportation companies
☐ Federally regulated exchanges ☐ Sales companies

F Check this box if you attached Form IL-4562. ☐
G Check this box if you attached Illinois Schedule M (for businesses). ☐
H Check this box if you attached Schedule 80/20. ☐
I Check this box if you attached Schedule 1299-A. ☐
J Check this box if you attached the Subgroup Schedule. ☐
K Check this box if you are a 52/53 week filer. ☐
L Check this box if you elected to file and pay Pass-through Entity Tax. See instructions. ☒
M If you are paying Pass-through Entity Tax and you annualized your income on Form IL-2220, check this box and **attach** Form IL-2220. ☐

N Enter your federal employer identification number (FEIN).
9 9 - 9 9 9 9 9 9 9

O ☐ Check this box if you are a member of a unitary business group and enter the FEIN of the member who prepared the Schedule UB, Combined Apportionment for Unitary Business Group. **Attach** Schedule UB to this return.
___ ___ - ___ ___ ___ ___ ___ ___ ___

P Enter your North American Industry Classification System (NAICS) Code. See instructions.
4 4 9 2 1 0

Q Enter your Illinois corporate file (charter) number issued by the Secretary of State.
____

R Enter the city, state, and zip code where your accounting records are kept. (Use the two-letter postal abbreviation, *e.g.*, IL, GA, etc.)
Champaign (City) IL (State) 61822 (ZIP)

S If you are making the business income election to treat all nonbusiness income as business income, check this box and enter zero on Lines 36 and 44. ☐

T If you have completed the following, check the box and **attach** the federal form(s) to this return.
☐ Federal Form 8886 ☐ Federal Sch. M-3, Part II, Line 10

U If you are making a discharge of indebtedness adjustment on Schedule NLD or Form IL-1120-ST, Line 48, check this box and **attach** federal Form 982. ☐

V Check this box if your business activity is protected under Public Law 86-272. ☐

Attach your payment and Form IL-1120-ST-V here.

Step 2: Figure your ordinary income or loss

			(Whole dollars only)
1	Ordinary income or loss, or equivalent from federal Schedule K.	1	113,000.00
2	Net income or loss from all rental real estate activities.	2	.00
3	Net income or loss from other rental activities.	3	0.00
4	Portfolio income or loss.	4	3,000.00
5	Net IRC Section 1231 gain or loss.	5	.00
6	All other items of income or loss that were not included in the computation of income or loss on Page 1 of U.S. Form 1120-S. See instructions. Identify: ____	6	.00
7	Add Lines 1 through 6. This is your ordinary income or loss.	7	116,000.00

Step 3: Figure your unmodified base income or loss

8	Charitable contributions.	8	.00
9	Expense deduction under IRC Section 179.	9	.00
10	Interest on investment indebtedness.	10	.00
11	All other items of expense that were not deducted in the computation of ordinary income or loss on Page 1 of U.S. Form 1120-S. See instructions. Identify: ____	11	.00
12	Add Lines 8 through 11.	12	.00
13	Subtract Line 12 from Line 7. This amount is your total unmodified base income or loss.	13	116,000.00

IR NS DR____

This form is authorized as outlined by the Illinois Income Tax Act. Disclosure of this information is REQUIRED. Failure to provide information could result in a penalty.

IL-1120-ST (R-12/22) Page 1 of 5

For Example 3

Step 4: Figure your income or loss

14	Enter the amount from Line 13. **Unitary filers**, enter the amount from Schedule UB, Step 2, Col E, Line 30.	14	116,000 .00
15	State, municipal, and other interest income excluded from Line 14.	15	.00
16	Illinois taxes and surcharge deducted in arriving at Line 14. See instructions.	16	7,000 .00
17	Illinois Special Depreciation addition. **Attach** Form IL-4562.	17	.00
18	Related-Party Expenses addition. **Attach** Schedule 80/20.	18	.00
19	Distributive share of additions. **Attach** Schedule(s) K-1-P or K-1-T.	19	.00
20	The amount of loss distributable to a shareholder subject to replacement tax. **Attach** Schedule B.	20	.00
21	Other additions. **Attach** Illinois Schedule M (for businesses).	21	.00
22	Add Lines 14 through 21. This amount is your income or loss.	22	123,000 .00

Step 5: Figure your base income or loss

23	Interest income from U.S. Treasury or other exempt federal obligations.	23	.00		
24	Share of income distributable to a shareholder subject to replacement tax. **Attach** Schedule B.	24	.00		
25	River Edge Redevelopment Zone Dividend subtraction. **Attach** Schedule 1299-A.	25	.00		
26	River Edge Redevelopment Zone Interest subtraction. **Attach** Schedule 1299-A.	26	.00		
27	High Impact Business Dividend subtraction. **Attach** Schedule 1299-A.	27	.00		
28	High Impact Business Interest subtraction. **Attach** Schedule 1299-A.	28	.00		
29	Contribution subtraction. **Attach** Schedule 1299-A.	29	.00		
30	Illinois Special Depreciation subtraction. **Attach** Form IL-4562.	30	.00		
31	Related-Party Expenses subtraction. **Attach** Schedule 80/20.	31	.00		
32	Distributive share of subtractions. **Attach** Schedule(s) K-1-P or K-1-T.	32	.00		
33	Other subtractions. **Attach** Schedule M (for businesses).	33	.00		
34	Total subtractions. Add Lines 23 through 33.			34	.00
35	**Base income or loss**. Subtract Line 34 from Line 22.			35	123,000 .00

STOP

A If the amount on Line 35 is derived inside Illinois only, check this box and enter the amount from Step 5, Line 35 on Step 7, Line 47. You may not complete Step 6. (You must leave Step 6, Lines 36 through 46 blank.) ☒

Note → If you are a unitary filer, do not check this box. Check the box on Line B and complete Step 6.

B If any portion of the amount on Line 35 is derived outside Illinois, or you are a unitary filer, check this box and complete all lines of Step 6. (Do not leave Lines 40 through 42 blank.) See instructions. ☐

Step 6: Figure your income allocable to Illinois (Complete only if you checked the box on Line B, above.)

36	Nonbusiness income or loss. **Attach** Schedule NB.			36	.00
37	Business income or loss included in Line 35 from non-unitary partnerships, partnerships included on a Schedule UB, S corporations, trusts, or estates. See instructions.			37	.00
38	Add Lines 36 and 37.			38	.00
39	Business income or loss. Subtract Line 38 from Line 35.			39	.00
40	Total sales everywhere. This amount cannot be negative.	40			
41	Total sales inside Illinois. This amount cannot be negative.	41			
42	Apportionment factor. Divide Line 41 by Line 40. Round to six decimal places.	42	.		
43	Business income or loss apportionable to Illinois. Multiply Line 39 by Line 42.			43	.00
44	Nonbusiness income or loss allocable to Illinois. **Attach** Schedule NB.			44	0 .00
45	Business income or loss apportionable to Illinois from non-unitary partnerships, partnerships included on a Schedule UB, S corporations, trusts, or estates. See instructions.			45	0 .00
46	**Base income or loss allocable to Illinois**. Add Lines 43 through 45.			46	.00

Page 2 of 5 IL-1120-ST (R-12/22)

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For Example 3

Step 7: Figure your net income

47	Base income or net loss from Step 5, Line 35, or Step 6, Line 46.	47	123,000 .00
48	Discharge of indebtedness adjustment. **Attach** federal Form 982. See instructions.	48	.00
49	Adjusted base income or net loss. Add Lines 47 and 48.	49	123,000 .00
50	Illinois net loss deduction. If Line 49 is zero or a negative amount, enter zero. **Attach** Schedule NLD. Check this box and attach a detailed statement if you have merged losses. ☐	50	.00
51	**Net income**. Subtract Line 50 from Line 49.	51	123,000 .00

Step 8: Figure the taxes, surcharges, pass-through withholding, and penalty you owe

52	Replacement tax. Multiply Line 51 by 1.5% (.015).	52	1,845 .00
53	Recapture of investment credits. **Attach** Schedule 4255.	53	.00
54	Replacement tax before investment credits. Add Lines 52 and 53.	54	1,845 .00
55	Investment credits. **Attach** Form IL-477.	55	.00
56	**Net replacement tax.** Subtract Line 55 from Line 54. If the amount is negative, enter zero.	56	1,845 .00
57	Compassionate Use of Medical Cannabis Program Act surcharge. See instructions.	57	.00
58	Sale of assets by gaming licensee surcharge. See instructions.	58	.00
59	Pass-through withholding you owe on behalf of your members. Enter the amount from Schedule B, Section A, Line 5. See instructions. **Attach** Schedule B.	59	.00
60	Pass-through entity income. See instructions. 60 123,000 .00		
61	**Pass-through entity tax**. Multiply Line 60 by 4.95% (.0495).	61	6,089 .00
62	**Total net replacement tax, surcharges, pass-through withholding, and pass-through entity tax you owe.** Add Lines 56, 57, 58, 59, and 61.	62	7,934 .00
63	Underpayment of estimated tax penalty from Form IL-2220. See instructions.	63	.00
64	**Total taxes, surcharges, pass-through withholding, and penalty**. Add Lines 62 and 63.	64	7,934 .00

Step 9: Figure your refund or balance due

65	Payments. See instructions.				
	a Credit from previous overpayments.	65a	.00		
	b Total payments made before the date this return is filed.	65b	7,000 .00		
	c Pass-through withholding reported to you. **Attach** Schedule(s) K-1-P or K-1-T.	65c	.00		
	d Illinois income tax withholding. **Attach** Form(s) W-2G.	65d	.00		
66	Total payments. Add Lines 65a through 65d.			66	7,000 .00
67	Overpayment. If Line 66 is greater than Line 64, subtract Line 64 from Line 66.			67	.00
68	Amount to be **credited forward**. See instructions. Check this box and attach a detailed statement if this carryforward is going to a different FEIN. ☐			68	.00
69	**Refund.** Subtract Line 68 from Line 67. This is the amount to be refunded.			69	.00

70 Complete to direct deposit your refund

Routing Number ☐☐☐☐☐☐☐☐☐ ☐ Checking or ☐ Savings

Account Number ☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐

71 **Tax Due.** If Line 64 is greater than Line 66 subtract Line 66 from Line 64. This is the amount you owe. 71 934 .00

Special Note → Enter the amount of your payment on the top of Page 1 in the space provided.

Step 10: Sign below

- Under penalties of perjury, I state that I have examined this return and, to the best of my knowledge, it is true, correct, and complete.

Sign Here	Signature of authorized officer	Date (mm/dd/yyyy)	Title	( ) Phone	☐ Check if the Department may discuss this return with the paid preparer shown in this step.

Paid Preparer Use Only	Print/Type paid preparer's name	Paid preparer's signature	Date (mm/dd/yyyy)	☐ Check if self-employed	Paid Preparer's PTIN
	Firm's name ▸			Firm's FEIN ▸	
	Firm's address ▸			Firm's phone ▸	( )

Refer to the 2022 IL-1120-ST Instructions for the address to mail your return.

IL-1120-ST (R-12/22) Printed by the authority of the state of Illinois. Electronic only, one copy. Page 3 of 5

For Example 3

Illinois Department of Revenue
2022 Schedule B

Veridian Innovations	99-9999999
Enter your name as shown on your Form IL-1065 or Form IL-1120-ST.	Enter your federal employer identification number (FEIN).

Section B: Members' information (See instructions before completing.)

	Member 1	Member 2	Member 3	Member 4
A Name	Isaac Evers	Mary Quinn	Victor Zimbalist	
C/O				
Address 1	2002 Warner Ave.	64 Harley Ln	4680 Fries Dr	
Address 2				
City	Champaign	Champaign	Champaign	
State, ZIP	IL 61822	IL 61822	IL 61822	
B Partner or Shareholder	I	I	I	
C SSN/FEIN	***-**-4567	***-**-5678	***-**-6789	
D Subject to Illinois replacement tax or an ESOP	☐	☐	☐	☐
E Member's distributable amount of base income or loss	61,500	30,750	30,750	
F Excluded from pass-through withholding	T	T	T	
G Share of Illinois income subject to pass-through withholding	0	0	0	
H Pass-through withholding before credits	0	0	0	
I Distributable share of credits	0	0	0	
J Pass-through withholding amount	0	0	0	
K PTE tax credit paid to members	3,045	1,522	1,522	
L PTE tax credit received and distributed to members	0	0	0	

Note: If you have more members than space provided, attach additional copies of this page as necessary.

Schedule B Back (R-12/22) Printed by the authority of the state of Illinois. Electronic only, one copy. Page 5 of 5

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For its federal return, Veridian prepares Form 1120-S, *U.S. Income Tax Return for an S Corporation,* reporting its income and expenses. Notably, the company deducts $27,000 of taxes on line 12 ($20,000 payroll tax + $7,000 state tax). If Veridian had not made the PTE tax election, the company would not have paid the $7,000 of estimated tax to Illinois. Instead, each shareholder would report the income on their Illinois tax return and pay the state income tax at their level. The Form 1120-S follows.

Form **1120-S** | **U.S. Income Tax Return for an S Corporation** | OMB No. 1545-0123

Department of the Treasury
Internal Revenue Service

Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.
Go to *www.irs.gov/Form1120S* for instructions and the latest information.

2022

For calendar year 2022 or tax year beginning , 2022, ending , 20

A S election effective date: **1/01/2002**	Name: **Veridian Innovations**	**D Employer identification number: 99-9999999**
B Business activity code number (see instructions): **449210**	TYPE OR PRINT — Number, street, and room or suite no. If a P.O. box, see instructions.: **2002 Warner Ave.**	**E** Date incorporated: **1/01/2002**
C Check if Sch. M-3 attached ☐	City or town, state or province, country, and ZIP or foreign postal code: **Champaign IL 61822**	**F** Total assets (see instructions): $ **238,700**

G Is the corporation electing to be an S corporation beginning with this tax year? See instructions. ☐ Yes ☒ No

H Check if: **(1)** ☐ Final return **(2)** ☐ Name change **(3)** ☐ Address change **(4)** ☐ Amended return **(5)** ☐ S election termination

I Enter the number of shareholders who were shareholders during any part of the tax year **3**

J Check if corporation: **(1)** ☐ Aggregated activities for section 465 at-risk purposes **(2)** ☐ Grouped activities for section 469 passive activity purposes

Caution: Include **only** trade or business income and expenses on lines 1a through 21. See the instructions for more information.

Income	1a	Gross receipts or sales	1a	300,000		
	b	Returns and allowances	1b			
	c	Balance. Subtract line 1b from line 1a			1c	300,000
	2	Cost of goods sold (attach Form 1125-A)			2	
	3	Gross profit. Subtract line 2 from line 1c			3	300,000
	4	Net gain (loss) from Form 4797, line 17 (attach Form 4797)			4	
	5	Other income (loss) (see instructions—attach statement)			5	
	6	**Total income (loss).** Add lines 3 through 5			6	300,000
Deductions (see instructions for limitations)	7	Compensation of officers (see instructions—attach Form 1125-E)			7	
	8	Salaries and wages (less employment credits)			8	160,000
	9	Repairs and maintenance			9	
	10	Bad debts			10	
	11	Rents			11	
	12	Taxes and licenses			12	27,000
	13	Interest (see instructions)			13	
	14	Depreciation from Form 4562 not claimed on Form 1125-A or elsewhere on return (attach Form 4562)			14	
	15	Depletion **(Do not deduct oil and gas depletion.)**			15	
	16	Advertising			16	
	17	Pension, profit-sharing, etc., plans			17	
	18	Employee benefit programs			18	
	19	Other deductions (attach statement)			19	
	20	**Total deductions.** Add lines 7 through 19			20	187,000
	21	**Ordinary business income (loss).** Subtract line 20 from line 6			21	113,000
		Ex... net passive income or LIFO recapture tax (see instructions)	22a			

For Example 3

Form 1120-S (2022) Page 3

Schedule B	Other Information (see instructions) *(continued)*	Yes	No
12	During the tax year, did the corporation have any non-shareholder debt that was canceled, was forgiven, or had the terms modified so as to reduce the principal amount of the debt?		
	If "Yes," enter the amount of principal reduction . . . $		
13	During the tax year, was a qualified subchapter S subsidiary election terminated or revoked? If "Yes," see instructions		
14a	Did the corporation make any payments in 2022 that would require it to file Form(s) 1099?		
b	If "Yes," did or will the corporation file required Form(s) 1099?		
15	Is the corporation attaching Form 8996 to certify as a Qualified Opportunity Fund?		
	If "Yes," enter the amount from Form 8996, line 15 . . . $		

Schedule K		Shareholders' Pro Rata Share Items				Total amount
Income (Loss)	1	Ordinary business income (loss) (page 1, line 21)			1	113,000
	2	Net rental real estate income (loss) (attach Form 8825)			2	
	3a	Other gross rental income (loss)	3a			
	b	Expenses from other rental activities (attach statement)	3b			
	c	Other net rental income (loss). Subtract line 3b from line 3a			3c	
	4	Interest income			4	3,000
	5	Dividends: a Ordinary dividends			5a	
		b Qualified dividends	5b			
	6	Royalties			6	
	7	Net short-term capital gain (loss) (attach Schedule D (Form 1120-S))			7	
	8a	Net long-term capital gain (loss) (attach Schedule D (Form 1120-S))			8a	
	b	Collectibles (28%) gain (loss)	8b			
	c	Unrecaptured section 1250 gain (attach statement)	8c			
	9	Net section 1231 gain (loss) (attach Form 4797)			9	
	10	Other income (loss) (see instructions) . . . Type:			10	
	11	Section 179 deduction (attach Form 4562)				

Isaac, Veridian's CEO, is a single taxpayer with no other source of income. He uses Schedule K-1 to prepare his Form 1040, *U.S. Individual Income Tax Return*, where he reports the activity on part II of Schedule E, *Supplemental Income and Loss*. Isaac reports the $56,500 of ordinary business income ($113,000 ordinary income × 50% ownership) from Schedule K-1, line 1 on Schedule E, part II, line 28. This flows to Schedule 1, *Additional Income and Adjustments to Income*, on line 5 for income from S corporations. The $56,500 then flows to line 8 on Form 1040, which is added to Isaac's share of interest income of $1,500 he reports on line 2b, which was included on Schedule K-1, line 4. Isaac's total AGI is $58,000 ($1,500 interest + $56,500 ordinary business income). Isaac's federal forms follow.

Observation. Without the PTE election and estimates paid by Veridian, Isaac's amount on line 1 of Schedule K-1 would be $60,000 ($56,500 ordinary business income + 50% of $7,000 state tax).

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For Example 3

671121

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1120-S) 2022
Department of the Treasury
Internal Revenue Service

For calendar year 2022, or tax year beginning 1 / 1 / 2022 ending 12 / 31 / 2022

Shareholder's Share of Income, Deductions, Credits, etc. See separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number
99-9999999

B Corporation's name, address, city, state, and ZIP code
Veridian Innovations
2002 Warner Ave
Champaign IL 61822

C IRS Center where corporation filed return
e-file

D Corporation's total number of shares
Beginning of tax year 100
End of tax year 100

Part II Information About the Shareholder

E Shareholder's identifying number
***-**-4567

F Shareholder's name, address, city, state, and ZIP code
Isaac Evers
2002 Warner Ave.
Champaign, IL 61822

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

1	Ordinary business income (loss)	56,500	13	Credits
2	Net rental real estate income (loss)			
3	Other net rental income (loss)			
4	Interest income	1,500		
5a	Ordinary dividends			
5b	Qualified dividends		14	Schedule K-3 is attached if checked . . . . . ☐
6	Royalties		15	Alternative minimum tax (AMT) items
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)		16	Items affecting shareholder basis
10	Other income (loss)			

Schedule E (Form 1040) 2022 Attachment Sequence No. 13 Page 2

Name(s) shown on return. Do not enter name and social security number if shown on other side.
Isaac Evers
Your social security number ***-**-4567

Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations

Note: If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column **(e)** on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column **(f)** on line 28 and attach **Form 6198**. See instructions.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section . . . . . ☐ Yes ☒ No

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
A	Veridian Innovations	S	☐	99-9999999	☐	☐
B			☐		☐	☐
C			☐		☐	☐
D			☐		☐	☐

	Passive Income and Loss		Nonpassive Income and Loss		
	(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1
A					56,500
B					
C					
D					
29a Totals					56,500
b Totals					

30	Add columns (h) and (k) of line 29a	30	56,500
31	Add columns (g), (i), and (j) of line 29b.	31	( )
32	**Total partnership and S corporation income or (loss).** Combine lines 30 and 31	32	56,500

Income or Loss From Estates and Trusts

For Example 3

Form 1040 Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2022** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

Filing Status Check only one box. ☒ Single ☐ Married filing jointly ☐ Married filing separately (MFS) ☐ Head of household (HOH) ☐ Qualifying surviving spouse (QSS)

If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QSS box, enter the child's name if the qualifying person is a child but not your dependent:

Your first name and middle initial	Last name	Your social security number
Isaac Evers		*** ** 4567
If joint return, spouse's first name and middle initial	Last name	Spouse's social security number

Home address (number and street). If you have a P.O. box, see instructions.		Apt. no.
2002 Warner Ave.		
City, town, or post office. If you have a foreign address, also complete spaces below.	State	ZIP code
Champaign	IL	61822
Foreign country name	Foreign province/state/county	Foreign postal code

Presidential Election Campaign Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

Digital Assets At any time during 2022, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.) ☐ Yes ☒ No

Standard Deduction **Someone can claim:** ☐ You as a dependent ☐ Your spouse as a dependent
☐ Spouse itemizes on a separate return or you were a dual-status alien

Age/Blindness **You:** ☐ Were born before January 2, 1958 ☐ Are blind **Spouse:** ☐ Was born before January 2, 1958 ☐ Is blind

Dependents (see instructions): If more than four dependents, see instructions and check here ☐

(1) First name Last name	(2) Social security number	(3) Relationship to you	(4) Child tax credit	(4) Credit for other dependents
			☐	☐
			☐	☐
			☐	☐
			☐	☐

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld. If you did not get a Form W-2, see instructions.

1a	Total amount from Form(s) W-2, box 1 (see instructions)		1a	
b	Household employee wages not reported on Form(s) W-2		1b	
c	Tip income not reported on line 1a (see instructions)		1c	
d	Medicaid waiver payments not reported on Form(s) W-2 (see instructions)		1d	
e	Taxable dependent care benefits from Form 2441, line 26		1e	
f	Employer-provided adoption benefits from Form 8839, line 29		1f	
g	Wages from Form 8919, line 6		1g	
h	Other earned income (see instructions)		1h	
i	Nontaxable combat pay election (see instructions)	1i		
z	Add lines 1a through 1h		1z	
2a	Tax-exempt interest	2a	b Taxable interest 2b	1,500
3a	Qualified dividends	3a	b Ordinary dividends 3b	
4a	IRA distributions	4a	b Taxable amount 4b	
5a	Pensions and annuities	5a	b Taxable amount 5b	
6a	Social security benefits	6a	b Taxable amount 6b	
c	If you elect to use the lump-sum election method, check here (see instructions) ☐			
7	Capital gain or (loss). Attach Schedule D if required. If not required, check here ☐		7	
8	Other income from Schedule 1, line 10		8	56,500
9	Add lines 1z, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your **total income**		9	58,000
10	Adjustments to income from Schedule 1, line 26		10	
11	Subtract line 10 from line 9. This is your **adjusted gross income**		11	58,000
12	**Standard deduction or itemized deductions** (from Schedule A)		12	
13	Qualified business income deduction from Form 8995 or Form 8995-A		13	
14	Add lines 12 and 13		14	
15	Subtract line 14 from line 11. If zero or less, enter -0-. This is your **taxable income**		15	

Attach Sch. B if required.

Standard Deduction for—
- Single or Married filing separately, $12,950
- Married filing jointly or Qualifying surviving spouse, $25,900
- Head of household, $19,400
- If you checked any box under *Standard Deduction*, see instructions.

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2022)

10

The $56,500 of pass-through income includes Isaac's share of the PTE tax that Veridian paid of $3,045 ($6,089 PTE tax × 50% ownership interest). Consequently, Isaac can deduct the Illinois income tax on his share of pass-through income from Veridian, regardless of whether he itemizes his expenses.

Isaac uses Schedule K-1-P to prepare his 2022 Form IL-1040, *Individual Income Tax Return*. He reports his federal AGI of $58,000 on line 1 but must add back $3,500 of Illinois tax (reported on Schedule K-1-P, line 33) to arrive at his Illinois base income of $61,500. After factoring in his Illinois exemption and property tax credit, Isaac calculates his Illinois income tax of $2,471. However, because Veridian paid PTE tax on his behalf, Isaac reports a PTE tax credit of $3,045 on line 28 of Form IL-1040. Isaac finds this amount on his Schedule K-1-P, line 53a. Because the refundable tax credit exceeds his tax liability, Isaac is due a refund of $574 ($3,045 PTE credit – $2,471 liability). Isaac's Illinois forms follow.

Illinois Department of Revenue

Schedule K-1-P

Partner's or Shareholder's Share of Income, Deductions, Credits, and Recapture

Year ending 12 (Month) 2022 (Year)

To be completed by partnerships filing Form IL-1065 or S corporations filing Form IL-1120-ST.

IL Attachment No. 12

Partners and Shareholders receiving Schedule K-1-P should attach this to their Illinois tax return.

Step 1: Identify your partnership or S corporation

1 Check your business type ☐ partnership ☒ S corporation

2 Veridian Innovations
Enter your name as shown on your Form IL-1065 or Form IL-1120-ST.

3 99-9999999
Enter your federal employer identification number (FEIN).

4 Enter the apportionment factor from Form IL-1065 or Form IL-1120-ST, Line 42. Otherwise, enter "1." 1

Step 2: Identify your partner or shareholder

5 Isaac Evers
Name

6 2002 Warner Ave.
Mailing address

Champaign IL 61822
City State ZIP

7 ***-**-4567
Social Security number or FEIN

8 50
Share (%)

9a Check the appropriate box. See instructions.
☒ individual ☐ corporation ☐ trust
☐ partnership ☐ S corporation ☐ estate

9b **To be completed by the recipient on Line 5 only.**
I am a: ☐ grantor trust ☐ disregarded entity
and the amounts on this schedule will be reported by:
Name: _____
SSN or FEIN: _____

Step 3: Figure your partner's or shareholder's share of your nonbusiness income or loss

			A Member's share (See instructions.)	B Member's share allocable to Illinois
10	Interest	10		
11	Dividends	11		
12	Rental income	12		
13	Patent royalties	13		
14	Copyright royalties	14		
15	Other royalty income	15		
16	Capital gain or loss from real property	16		
17	Capital gain or loss from tangible personal property	17		
18	Capital gain or loss from intangible personal property	18		
19	Other income and expense _____ Specify	19		

Step 4: Figure your partner's or shareholder's share of your business income or loss

			A Member's share from U.S. Schedule K-1, less nonbusiness income	B Member's share apportioned to Illinois
20	Ordinary income or loss from trade or business activity	20	56,500	56,500
21	Net income or loss from rental real estate activities	21		
22	Net income or loss from other rental activities	22		
23	Interest	23	1,500	1,500
24	Dividends	24		
25	Royalties	25		
26	Net short-term capital gain or loss	26		
27	Net long-term capital gain or loss. Total for year.	27		
28	Unrecaptured Section 1250 gain	28		
29	Guaranteed payments to partner (U.S. Form 1065 only)	29		
30	Net Section 1231 gain or loss (other than casualty or theft). Total for year.	30		
31	Other income and expense _____ Specify	31		

Schedule K-1-P Front (R-12/22)

This form is authorized as outlined by the Illinois Income Tax Act. Disclosure of this information is REQUIRED. Failure to provide this information could result in a penalty.

For Example 3

Enter identification number from Line 7.
***-**-4567

Step 5: Figure your partner's or shareholder's share of Illinois additions and subtractions

K-1-P Recipient: Before using the information provided in Step 5, you must read Schedule K-1-P(2) to correctly report the amounts listed in Columns A and B.

		A Member's share from Form IL-1065 or IL-1120-ST	B Member's share apportioned or allocated to Illinois
Additions			
32 Federally tax-exempt interest income	32		
33 Illinois taxes and surcharge deducted. See instructions.	33	3,500	3,500
34 Illinois Special Depreciation addition	34		
35 Related-Party Expenses addition	35		
36 Distributive share of additions	36		
37 Other additions (from Illinois Schedule M for businesses)	37		
Subtractions			
38 a Interest from U.S. Treasury obligations (business income)	38a		
b Interest from U.S. Treasury obligations (nonbusiness income)	38b		
39 River Edge Redevelopment Zone Dividend subtraction	39		
40 High Impact Business Dividend subtraction	40		
41 Contribution subtraction (Form IL-1120-ST filers only)	41		
42 River Edge Redevelopment Zone Interest subtraction (Form IL-1120-ST financial organizations only)	42		
43 High Impact Business within a Foreign Trade Zone Interest subtraction (Form IL-1120-ST financial organizations only)	43		
44 Illinois Special Depreciation subtraction	44		
45 Related-Party Expenses subtraction	45		
46 Distributive share of subtractions	46		
47 Other subtractions (from Illinois Schedule M for businesses)	47		

Step 6: Figure your partner's or shareholder's (except a corporate partner or shareholder) share of your Illinois August 1, 1969, appreciation amounts

		A Member's share from Illinois Schedule F (Form IL-1065 or IL-1120-ST)	B Member's share apportioned or allocated to Illinois
48 Section 1245 and 1250 gain	48		
49 Section 1231 gain	49		
50 Section 1231 gain less casualty and theft gain. See instructions.	50		
51 Capital gain	51		

Step 7: Figure your partner's or shareholder's share of your Illinois credits, recapture, pass-through withholding, pass-through entity tax credit, and federal income subject to surcharge

52 Illinois Income Tax Credits	Credit Code		Member's share from Illinois tax return
a Film Production Services	5000	52a	
b Enterprise Zone Investment	5080	52b	
c Enterprise Zone Construction Jobs	5120	52c	
d High Impact Business Construction Jobs	5160	52d	
e Affordable Housing Donations	5260	52e	
f EDGE	5300	52f	
g New Construction EDGE	5320	52g	
h Research and Development	5340	52h	
i Wages Paid to Ex-Felons	5380	52i	
j Student-Assistance Contributions	5420	52j	
k Angel Investment	5460	52k	
l New Markets Development	5500	52l	
m River Edge Historic Preservation	5540	52m	
n River Edge Construction Jobs	5560	52n	
o Live Theater Production	5580	52o	
p Hospital	5620	52p	
q Invest in Kids	5660	52q	
r Data Center Construction Employment	5820	52r	
s Apprenticeship Education Expense	0160	52s	
t Historic Preservation	1030	52t	
u REV Illinois Investment	5230	52u	
v Agritourism Liability Insurance	5440	52v	
w Recovery and Mental Health	0180	52w	
x Other income tax credits ________		52x	

		Member's share from Illinois tax return
53 Other credits		
a Pass-through Entity (PTE) Tax Credit See instructions.	53a	3,045
b Replacement Tax Investment Credits See instructions.	53b	
54 Recapture		
a Enterprise Zone or River Edge Redevelopment Zone Investment Credit recapture	54a	
b REV Illinois Investment Credit recapture	54b	
c Replacement Tax Investment Credit recapture	54c	
d Additional income tax credit recapture	54d	
55 Pass-through withholding See instructions.	55	
56 Federal income attributable to transactions subject to the Compassionate Use of Medical Cannabis Program Act surcharge. See instructions.	56	
57 Federal income attributable to the sale or exchange of assets by a gaming licensee surcharge. See instructions.	57	

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Schedule K-1-P Back (R-12/22)

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For Example 3

Illinois Department of Revenue
2022 Form IL-1040
Individual Income Tax Return

or for fiscal year ending __ __/__ __

Step 1: Personal Information Enter personal information and Social Security numbers (SSN). You must provide the entire SSN(s) - no partial SSN.

A Your first name and middle initial	Your last name	Year of birth	Your social security number
Isaac	Evers	1 9 8 7	***-**-4567
Spouse's first name and middle intial	Spouse's last name	Spouse's year of birth	Spouse's social security number

Mailing address (See inst. if foreign address)	Apartment number	City	State	Zip or postal code
2002 Warner Ave.		Champaign	IL	61822
Foreign nation if not US (do not abbreviate)	County (Illinois only)	Email address		

B Filing status: ☒ Single ☐ Married filing jointly ☐ Married filing separately ☐ Widowed ☐ Head of household

C Check If someone can claim you, or your spouse if filing jointly, as a dependent. See instructions. ☐ You ☐ Spouse

D Check the box if this applies to you during 2022: ☐ Nonresident - **Attach** Sch. NR ☐ Part-year resident - **Attach** Sch. NR

(Whole dollars only)

Step 2: Income

1	Federal adjusted gross income from your federal Form 1040 or 1040-SR, Line 11.		1 58,000 .00
2	Federally tax-exempt interest and dividend income from your federal Form 1040 or 1040-SR, Line 2a.		2 .00
3	Other additions. **Attach** Schedule M.		3 3,500 .00
4	**Total income**. Add Lines 1 through 3.		4 61,500 .00

Step 3: Base Income

5	Social Security benefits and certain retirement plan income received if included in Line 1. **Attach** Page 1 of federal return.	5 .00	
6	Illinois Income Tax overpayment included in federal Form 1040 or 1040-SR, Schedule 1, Ln. 1.	6 .00	
7	Other subtractions. **Attach** Schedule M.	7 .00	
8	Add Lines 5, 6, and 7. This is the total of your subtractions.		8 .00
9	**Illinois base income**. Subtract Line 8 from Line 4.		9 61,500 .00

Step 4: Exemptions

10	**a** Enter the exemption amount for yourself and your spouse. **See instructions.**	a 2,425 .00	
	b Check if 65 or older: ☐ You **+** ☐ Spouse **# of checkboxes X** $1,000 **=**	b .00	
	c Check if legally blind: ☐ You **+** ☐ Spouse **# of checkboxes X** $1,000 **=**	c .00	
	d If you are claiming dependents, enter the amount from Schedule IL-E/EIC, Step 2, Line 1. **Attach** Schedule IL-E/EIC.	d .00	
	Exemption allowance. Add Lines 10a through 10d.		10 2,425 .00

Step 5: Net Income and Tax

11	***Residents:*** **Net income**. Subtract Line 10 from Line 9. ***Nonresidents and part-year residents:*** Enter the **Illinois net income** from Schedule NR. **Attach** Schedule NR.	11 59,075 .00
12	***Residents:*** Multiply Line 11 by 4.95% (.0495). Cannot be less than zero. ***Nonresidents and part-year residents:*** Enter the tax from Schedule NR.	12 2,924 .00
13	Recapture of investment tax credits. **Attach** Schedule 4255.	13 .00
14	**Income tax.** Add Lines 12 and 13. Cannot be less than zero.	14 2,924 .00

Step 6: Tax After Nonrefundable Credits

15	Income tax paid to another state while an Illinois resident. **Attach** Schedule CR.	15 .00	
16	Property tax and K-12 education expense credit amount from Schedule ICR. **Attach** Schedule ICR.	16 453 .00	
17	Credit amount from Schedule 1299-C. **Attach** Schedule 1299-C.	17 .00	
18	Add Lines 15, 16, and 17. This is the total of your credits. Cannot exceed the tax amount on Line 14.		18 453 .00
19	**Tax after nonrefundable credits.** Subtract Line 18 from Line 14.		19 2,471 .00

Step 7: Other Taxes

20	Household employment tax. See instructions.	20 .00
21	Use tax on internet, mail order, or other out-of-state purchases from UT Worksheet or UT Table in the instructions. **Do not** leave blank.	21 0 .00
22	Compassionate Use of Medical Cannabis Program Act and sale of assets by gaming licensee surcharges.	22 .00
23	**Total Tax**. Add Lines 19, 20, 21, and 22.	23 2,471 .00

Staple W-2 and 1099 forms here

Staple your check and IL-1040-V

IL-1040 Front (R-12/22) Printed by authority of the state of Illinois. Electronic only, one copy.

This form is authorized as outlined under the Illinois Income Tax Act. Disclosure of this information is required. Failure to provide information could result in a penalty.

For Example 3

24	Total tax from Page 1, Line 23.		24	2,471 .00
Step 8: Payments and Refundable Credit				
25	Illinois Income Tax withheld. **Attach** Schedule IL-WIT.	25 .00		
26	Estimated payments from Forms IL-1040-ES and IL-505-I, including any overpayment applied from a prior year return.	26 .00		
27	Pass-through withholding. **Attach** Schedule K-1-P or K-1-T.	27 .00		
28	Pass-through entity tax credit. **Attach** Schedule K-1-P or K-1-T.	28 3,045 .00		
29	Earned Income Credit from Schedule IL-E/EIC, Step 4, Line 8. **Attach** Schedule IL-E/EIC.	29 .00		
30	**Total payments and refundable credit**. Add Lines 25 through 29.		30	3,045 .00
Step 9: Total				
31	If Line 30 is greater than Line 24, subtract Line 24 from Line 30.		31	574 .00
32	If Line 24 is greater than Line 30, subtract Line 30 from Line 24.		32	.00
Step 10: Underpayment of Estimated Tax Penalty and Donations				
33	Late-payment penalty for underpayment of estimated tax.	33 .00		
	a ☐ Check if at least two-thirds of your federal gross income is from farming.			
	b ☐ Check if you or your spouse are 65 or older and permanently living in a nursing home.			
	c ☐ Check if your income was not received evenly during the year and you annualized your income on Form IL-2210. **Attach** Form IL-2210.			
	d ☐ Check if you were not required to file an Illinois Individual Income Tax return in the previous tax year.			
34	Voluntary charitable donations. **Attach** Schedule G.	34 .00		
35	**Total penalty and donations**. Add Lines 33 and 34.		35	.00
Step 11: Refund or Amount you owe				
36	If you have an amount on Line 31 and this amount is greater than Line 35, subtract Line 35 from Line 31. This is your **overpayment**.		36	574 .00
37	Amount from Line 36 you want **refunded to you**. Check **one** box on Line 38. See instructions.		37	574 .00
38	I choose to receive my refund by			
	a ☐ **direct deposit** - Complete the information below if you check this box.			
	You may also contribute to college savings funds here. See instructions! Routing number ☐ Checking or ☐ Savings; Account number			
	b ☒ **paper check.**			
39	Amount to be **credited forward.** Subtract Line 37 from Line 36. See instructions.		39	.00
40	If you have an amount on Line 32, add Lines 32 and 35. **- or -** If you have an amount on Line 31 and this amount is less than Line 35, subtract Line 31 from Line 35. This is the **amount you owe**. See instructions.		40	.00

Step 12: Health Insurance Checkbox and Signature

41 ☐ Check this box if IDOR may share your income information with other Illinois state agencies in order to determine your eligibility for health insurance benefits. See instructions for more information.

Signature - Note: If this is a joint return, both you and your spouse must sign below.
Under penalties of perjury, I state that I have examined this return and, to the best of my knowledge, it is true, correct, and complete.

Sign Here	Your signature	Date (mm/dd/yyyy)	Spouse's signature	Date (mm/dd/yyyy)	Daytime phone number ( )
Paid Preparer Use Only	Print/Type paid preparer's name		Paid preparer's signature	Date (mm/dd/yyyy)	☐ Check if self-employed; Paid Preparer's PTIN
	Firm's name ▸	**University of Illinois Tax School**		Firm's FEIN ▸	
	Firm's address ▸	**1301 West Gregory Drive Urbana IL 61801**		Firm's phone ▸	( )
Third Party Designee	Designee's name (please print)		Designee's phone number ( )		☒ Check if the Department may discuss this return with the third party designee shown in this step.

Refer to the 2022 IL-1040 Instructions for the address to mail your return.

IL-1040 Back (R-12/22) DR____ AP____ RR DC IR ID

10

CONCLUSION

The PTE tax election is an avenue to obtain a tax benefit beyond the $10,000 SALT limit for state income tax on pass-through income. The appeal of this method is dependent on the benefit of the federal tax deduction in comparison to the nuances and hurdles of navigating through a state's laws and procedures regarding the PTE tax. The shareholders' tax situations also drive the decision-making process in evaluating the benefits of the PTE tax election. Another factor to consider is the time and effort to plan, implement, and execute the PTE tax election.

Practitioner Planning Tip

Each state's laws, procedures, and requirements regarding the PTE tax election are different, and the shareholders' tax positions can vary widely. PTEs and their tax practitioners should utilize the discussion points and considerations to assess whether adopting the PTE tax election is an optimal strategy for them to apply in their specific circumstances.

CORPORATE TRANSPARENCY ACT

In 2021, Congress passed the Corporate Transparency Act[43] that subjects certain companies operating in and from the United States to additional reporting requirements to the Financial Crimes Enforcement Network (FinCEN). Congress's goal is to curtail money laundering and terrorism financing through companies by providing law enforcement and security agencies with information on the owners of existing and new businesses.[44] With these requirements being effective on **January 1, 2024,** company owners and tax practitioners need to familiarize themselves with the provisions of the Corporate Transparency Act and plan accordingly.[45]

REPORTING COMPANIES

The entities subject to the new beneficial ownership information reporting requirements mandated by the Corporate Transparency Act are known as **reporting companies.** Reporting companies consist of any corporation, limited liability company (LLC), or other entity created by a filing with a secretary of state.[46] This definition also applies to foreign companies created under foreign law but registered to do business in the United States by filing with a secretary of state.[47] S corporations, C corporations, and partnerships more than likely have filed with a secretary of state to conduct business within that state. Depending on the state and facts and circumstances, sole proprietors may require filing with a secretary of state.[48]

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43. The *Corporate Transparency Act* was enacted as part of the *Anti-Money Laundering Act of 2020*, which added new Section 31 USC 5336 to the Bank Secrecy Act.

44. *Corporate Transparency Act*, §6402.

45. *Beneficial Ownership Information Reporting Requirements*. Sep. 30, 2022. Financial Crimes Enforcement Network. [www.federalregister.gov/documents/2022/09/30/2022-21020/beneficial-ownership-information-reporting-requirements] Accessed on Jul. 27, 2023.

46. 31 USC §5336(a)(11)(A).

47. Ibid.

48. To look up the requirements by state, see *Business Formation Laws and Forms: 50-State Survey.* Oct. 2022. Justia. [www.justia.com/business-operations/business-forms-50-state-resources] Accessed on Jul. 27, 2023.

Practitioner Planning Tip

Practitioners should check with their clients to verify if they made such filings to determine whether they may be subject to the reporting requirements under the Corporate Transparency Act.

While the definition of a reporting company is broad, there are numerous exceptions that the law does not consider as reporting companies. The following **are not reporting companies** subject to additional disclosure requirements.[49]

- Publicly traded companies and entities filing reports with the Securities and Exchange Commission (SEC)
- Entities exercising governmental authority on behalf of the U.S. government
- Banks, credit unions, bank holding companies, and registered money-transmitting businesses
- Securities brokers and dealers
- Entities registered with the SEC
- Investment advisors
- Insurance companies
- Public accounting firms
- Public utility providers
- Non-profit organizations, including charities, political organizations, and trusts
- Entities employing **over 20 full-time employees** with **over $5 million in gross receipts** for the previous year (including receipts for entities for which it owns or is owned) that have an operating presence at a **physical office located in the United States**
- Entities existing for over one year not actively engaged in business, not directly or indirectly owned by a foreign person, did not change ownership, or send or receive over $1,000 in the last year, and do not hold any assets, including ownership in other entities
- Entities that the Secretary of the Treasury, the Attorney General, and the Secretary of Homeland Security have jointly determined are not subject to the reporting requirements due to such information not serving the public interest and not being useful to securities agencies or law enforcement in their efforts to prevent money laundering, financing terrorism, and other financial crimes

[49]. 31 USC §5336(a)(11)(B).

BENEFICIAL OWNERSHIP INFORMATION

As mentioned previously, the information disclosure mandated by the Corporate Transparency Act pertains to information about a reporting company's ownership. Specifically, reporting companies must submit information on all beneficial owners and the applicant, collectively known as **beneficial ownership information.** A **beneficial owner** is an individual or entity directly or indirectly exercising substantial control over the entity and owns or controls at least 25% of the entity's ownership interests.[50] An **applicant** is an individual who applies through a filing to form an entity under a state's laws or, in the case of a foreign entity, register with a secretary of state to do business in the United States.[51]

Required Beneficial Ownership Information[52]

Reporting companies required to submit beneficial ownership information must disclose the following information for each beneficial owner and applicant of the entity.

1. Name
2. Date of birth
3. Current residential or business address
4. Unique identification number or FinCEN identifier

Unique identification numbers must derive from a nonexpired U.S. passport, state identification card, or driver's license. A nonexpired foreign passport is acceptable if a beneficial owner or applicant does not have such documents.[53] A FinCEN identifier is an alternative identification number provided by FinCEN. An individual must provide FinCEN with the aforementioned required information to receive a FinCEN identifier for use in a beneficial ownership information report.[54]

Required Reporting Company Information

While the Corporate Transparency Act does not specify the information a reporting company must provide about the entity itself, FinCEN issued guidance identifying what information they require reporting companies to disclose. Reporting companies must include the following information about the reporting company in their report.[55]

1. Full name
2. Trade name or "doing business as" name
3. Business street address
4. State of formation
5. IRS taxpayer identification number (TIN)

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50. 31 USC §5336(a)(3)(A).
51. 31 USC §5336(a)(2).
52. 31 USC §5336(b)(2)(A).
53. 31 USC §5336(a)(1).
54. 31 USC §5336(b)(3).
55. *Beneficial Ownership Information Reporting Requirements*. Sep. 30, 2022. Financial Crimes Enforcement Network. [www.federalregister.gov/documents/2022/09/30/2022-21020/beneficial-ownership-information-reporting-requirements] Accessed on Jul. 27, 2023.

Recipient of the Filed Information[56]

FinCEN will receive and process the information in the filed beneficial ownership reports. While FinCEN must maintain the confidentiality of the report's contents, they are authorized to provide the information contained therein to federal agencies in the intelligence, national security, and law enforcement fields. Additionally, state or local law enforcement may receive the information for use in a criminal or civil investigation as authorized by a court of competent jurisdiction. Financial institutions may receive the filed information to comply with customer due diligence requirements.

FILING REQUIREMENTS[57]

Reporting companies must submit a report containing beneficial ownership information to FinCEN electronically through its website, **www.fincen.gov**. FinCEN will accept reports beginning on January 1, 2024. Reporting companies created **before January 1, 2024,** must submit their beneficial ownership information report by **January 1, 2025.** Reporting companies created on or after January 1, 2024, must submit their initial report **within 30 days of their creation.** All reporting companies must file updated FinCEN reports within 30 days of any changes to required beneficial ownership information or reporting company information disclosed in a filed report. Consequently, filers must be aware of and track any changes in reporting information to maintain compliance with the Corporate Transparency Act. There is no fee for submitting the report to FinCEN.

FAILURE OF COMPLIANCE[58]

If reporting companies **willfully fail to file** a beneficial ownership information report or provide false or fraudulent information, they may be subject to criminal and civil penalties. The penalty is $500 per day the violation continues or has not been remedied, but shall not exceed $10,000 and not include imprisonment exceeding two years. The penalties for **unauthorized use or disclosure** of beneficial ownership information are more severe, with penalties not to exceed $250,000 and imprisonment not exceeding five years. However, if a filer believes a report contains inaccurate information and voluntarily submits a corrected report within 90 days of filing the erroneous report, the filer will not incur a penalty. This safe harbor against penalties does not apply to filers who, when filing, knew the report contained inaccuracies and purposefully acted to evade the reporting requirements.

Practitioner Planning Tip

As the penalty for noncompliance is high, entities must identify whether they are subject to reporting requirements. If they are required to file a report with FinCEN, reporting companies must accumulate the required information and submit it promptly. As this is a new rule that will begin in 2024, practitioners can provide value to their clients by alerting them to this new requirement and directing them to authoritative guidance to aid in their assessment, collecting, and submission of beneficial ownership information to avoid noncompliance with the Corporate Transparency Act.

56. 31 USC §5336(c)(2).

57. *Beneficial Ownership Information Reporting Frequently Asked Questions.* 2023. Financial Crimes Enforcement Network. [www.fincen.gov/boi-faqs] Accessed on Jul. 27, 2023.

58. 31 USC §5336(h).

FORM 7203

In recent years, the IRS has faced pressure to ensure that S corporation shareholders properly calculate their basis in S corporations,[59] and in December 2021, released Form 7203, *S Corporation Shareholder Stock and Debt Basis Limitations*. This section discusses how tax professionals can use Form 7203 to protect their clients' interests, properly report items on their tax return, and maintain their compliance with the Code and treasury regulations regarding basis.

The **shareholder** files Form 7203, not the S corporation. **It is the shareholder's responsibility to maintain their basis amounts.**

FORM 7203 OVERVIEW[60]

Accurately calculating basis is essential in gain or loss calculations because it affects the amount of taxable income or loss an individual or business reports on their tax return. Basis determines the amount of gain or loss on the sale or disposition of property, including stock of an S corporation.[61] If the basis is reported inaccurately, it can result in the underreporting or overreporting of income or losses.

The instructions for Form 7203 state that the IRS requires the form in the following circumstances.

- The shareholder is claiming a deduction for an aggregate loss from an S corporation that was not allowed in the previous year because they lacked basis
- The shareholder received a distribution from an S corporation
- The shareholder disposed of stock in an S corporation, even if no gain was recognized
- The shareholder received a loan repayment from an S corporation

In other words, anytime a taxable gain could be missed because a taxpayer's basis in an S corporation was miscalculated, they must file Form 7203 with their Form 1040. Although the dependence on accurate basis calculations is well established when a taxpayer disposes of stock, it is a less-established issue when a loan repayment is made, as discussed later.

Practitioner Planning Tip

Despite the requirement to file Form 7203 only for the individuals listed previously in the year required, tax practitioners should prepare Form 7203 each year because they will need the information in a future year.

59. *Tax Gap: Action Needed to Address Noncompliance with S Corporation Tax Rules.* Jan. 14, 2010. U.S. Government Accountability Office. [www.gao.gov/products/gao-10-195] Accessed on Jul. 11, 2023.

60. Instructions for Form 7203; See Form 7203.

61. IRC §1001(a).

Shareholder Identification

A shareholder enters their name on the first line of the form, and their social security number, if a natural person. If a taxpayer files a joint return and their spouse also receives a Schedule K-1 from the S corporation, the spouse must file a separate Form 7203. If the shareholder is an eligible estate,[62] an eligible trust,[63] or eligible charity,[64] their name should be entered on this line and their employer identification number (EIN) in the box labeled "Identifying number."

The S corporation itself is named on line A immediately beneath the shareholder's name. Its EIN is entered in the box B labeled "Employer identification number."

Tracking Stock Acquisition Block-by-Block (Item C)[65]

Form 7203, item C provides a space to enter a stock block's identification. If more than one block of stock exists, shareholders should expect to file multiple copies of Form 7203.

> **Note.** Taxpayers may be required to file multiple Forms 7203 if during the year, there were capital contributions with different bases.[66] Each form is clearly distinguished by the indication of its stock block in item C near the top of the form's first page.

The form's instructions suggest that tracking different blocks is important when a partial stock sale or partial stock redemption occurs. Different stock blocks can have different bases.

Stock Acquisition Method (Item D)[67]

New for the 2022 version of Form 7203, a shareholder has five options to select as to how they acquired their stock.

1. Original shareholder
2. Purchased
3. Inherited
4. Gift
5. Other, which requires additional explanation by the shareholder

Practitioner Planning Tip

The presence of a gift option on Form 7203 suggests that shareholders who give their stock to another may wish to document the gift with a letter stating their basis in the stock and retain any copies of Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*, that they may be required to file.

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62. IRC §1361(c)(3).
63. IRC §1361(c)(2).
64. IRC §1361(c)(6).
65. Treas. Reg. §§1.1367-1(b)(2) and (c)(3).
66. Instructions for Form 7203 (2022).
67. Ibid.

Treas. Reg. §1.1367-1(g) Election (Item E)

New for the 2022 version of Form 7203 is an area for a shareholder to indicate they have elected to flip the order in which the following are deducted from their stock basis.

- Nondeductible and noncapital expenses,[68] as well as any oil and gas depletion deduction[69]
- Separately stated and non-separately stated items of loss and deduction[70]

Taxpayers may benefit from this election if their stock basis in an S corporation is less than their share of its nondeductible and noncapital expenses. This election allows the taxpayer to deduct separately stated expenses in the year they incur them instead of carrying them forward to the next year. A carryforward to the next year can occur if the nondeductible expenses have reduced basis before the separately stated expenses have reduced basis.

> **Note.** At first glance, making this election seems to be an easy decision. However, under the default method, the nondeductible losses **do not** carry forward to reduce basis in future years. Conversely, under the elective method, nondeductible losses in excess of basis **do** carry forward to reduce basis in future years. Accordingly, more basis is preserved over the long run when the default method is used rather than the elective method under Treas. Reg. §1.1367-1(g).

STOCK BASIS

Determining stock basis is the first step in calculating a shareholder's overall basis. Contributions to the S corporation's capital are added to the shareholder's stock basis.[71]

Ordering Rules

The sequence of **adjustments to stock** basis appears in four steps.[72]

1. Increase in basis attributable to income items (Form 7203, line 3)
2. Decrease in stock basis due to a distribution (Form 7203, line 6)
3. Decrease due to nondeductible expenses (Form 7203, line 8)
4. Decrease due to items of loss (Form 7203, line 11)

The treasury regulations apply these four items on the last day of the tax year, generally December 31 for an S corporation, unless the shareholder disposed of stock during the year.[73]

68. Treas. Reg. §1.1367-1(f)(3), referencing IRC §1367(a)(2)(D).
69. IRC §1367(a)(2)(E).
70. IRC §§1367(a)(2)(B) and (C).
71. *S Corporation Stock and Debt Basis.* Oct. 13, 2022. IRS. [www.irs.gov/businesses/small-businesses-self-employed/s-corporation-stock-and-debt-basis] Accessed on Jul. 26, 2023.
72. IRC §1367; Treas. Reg. §1.1367-1(f).
73. Treas. Reg. §1.1367-1(d)(1).

Income Items.[74] A shareholder's stock basis is increased by the following items of income.

- Ordinary business income
- Net rental real estate income
- Other net rental income
- Interest income
- Dividend income
- Royalties
- Capital gains
- Net IRC §1231 gain
- Other income
- Tax-exempt income

Distributions.[75] Distributions must be made from an S corporation's stock basis, not its debt basis. Only nondividend distributions reduce stock basis; dividend distributions generally do not.[76] The S corporation is responsible for informing the shareholder of the amount of nondividend and dividend distributions.[77] A nondividend distribution in excess of stock basis is taxed as a capital gain on the shareholder's personal return. It is a long-term capital gain (LTCG) if the S corporation stock has been held for longer than one year.[78]

Nondividend distributions generally decrease basis because they are not included in a shareholder's income. Under some circumstances, however, nondividend distributions may be included in income. This would result in the nondividend distribution **not** reducing basis. This could happen if a shareholder receives a nondividend distribution despite having $0 stock basis. Because these distributions are only taken from stock basis and not debt basis, basis is only decreased if they are **not** included in the shareholder's income. If they are included in income because the shareholder has an insufficient stock basis, some or all of the distribution may be included in the shareholder's net increase.[79] These are treated as gain from the sale or exchange of property.[80] In this case, the taxable portion of the distribution is reported on the shareholder's Schedule D, *Capital Gains and Losses*, and not on Form 7203, on which distributions are normally reported.[81]

Nondeductible Expenses. Nondeductible expenses reduce a shareholder's stock and/or debt basis before loss and deduction items. If nondeductible expenses exceed stock and/or debt basis, they do not carryforward unless the taxpayer makes the §1.1367-1(g) election.[82] The nondeductible portion of meals expense and the oil and gas depletion deduction under IRC §1367(a)(2)(E) also decrease basis.[83]

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74. Instructions for Form 1120-S.
75. *S Corporation Stock and Debt Basis.* Oct. 13, 2022. IRS. [www.irs.gov/businesses/small-businesses-self-employed/s-corporation-stock-and-debt-basis] Accessed on Aug. 1, 2023.
76. IRC §1368(c).
77. 2022 Instructions for Form 1120-S, p. 24.
78. *S Corporation Stock and Debt Basis.* Oct. 13, 2022. IRS. [www.irs.gov/businesses/small-businesses-self-employed/s-corporation-stock-and-debt-basis] Accessed on Jul. 25, 2023.
79. IRC §1367(a)(2)(A).
80. IRC §§1368(b)(1) and (2).
81. Instructions for Form 7203.
82. Ibid.
83. Treas. Reg. §1.1367-1(f)(3).

Losses. A shareholder's stock basis is further reduced by losses and certain deductions. These include the following.[84]

- Ordinary business loss
- Net rental real estate loss
- Other net rental loss
- Capital losses
- Net §1231 loss
- Other losses
- IRC §179 expense deduction[85]

However, these items cannot reduce a shareholder's stock basis below $0.[86] If a loss is greater than remaining basis, it is carried forward subject to allocation with other loss limitations.[87]

Part I — Shareholder Stock Basis

Part I addresses adjustments to **stock basis.** The following section highlights some of the information reported on part I.

Capital Contributions (line 2). Any additional capital contributions are recorded on line 2 along with any stock purchases made during the year. The value of the basis recorded depends on how a taxpayer acquired the stock.

- **Purchased stock** is generally recorded at cost.[88]
- For **contributed property** in an IRC §351 exchange for stock, the stock basis is generally the carryover basis of assets transferred to the S corporation less the liabilities assumed by the S corporation.[89] This applies when the contributing shareholder controls at least 80% of the S corporation's stock.[90]
- **Inherited property** is generally fair market value (FMV) at the date of death or the alternate valuation date.[91]
- **Gifted stock** is generally the basis of the stock in the hands of the donor.[92]
- Stock received as **compensation** is recorded at FMV on the date the compensation is included in income.[93]
- **Noncash contributions** other than IRC §351 exchanges are valued at their basis in the hands of the shareholder. The shareholder increases their basis by the amount of any gain they recognize in making the transfer,[94] assuming no liabilities are transferred to the S corporation. However, the shareholder's basis is limited to the contributed property's FMV on the contribution date.[95]

84. See Instructions for Form 1120-S.
85. IRC §1366(a)(1).
86. IRC §1367(a)(2).
87. Treas. Reg. §1.1366-2(a)(3).
88. IRC §1012.
89. See IRC §358 for more information on the basis of stock received in a §351 transaction.
90. IRC §368(c).
91. See IRC §1014 and Treas. Reg. §1.1014-4 for more information.
92. See Treas. Regs. §§1.1015-1, 1.1366-2(a)(6), and 1.1366-2(a)(7).
93. See IRS Pub. 551, *Basis of Assets.*
94. IRC §362(a). See also IRC §1371 for the application of C corporation rules to S corporations.
95. IRC §362(d)(1).

Example 4. Sam incorporated Alpha Corporation on January 2, 2022, funding it with $2,000 of capital contributions, and immediately filed an S corporation election. In return, Sam acquired 200 shares of Alpha common stock.

After incorporation, Alpha has $2,000 in its bank account, and Sam has a $2,000 stock basis from his 2022 contributions. During 2022, Alpha loses $1,728, reducing Sam's stock basis at the end of the year to $272 ($2,000 – $1,728). Sam reports these transactions on the following Form 7203, part I.

Form **7203** (Rev. December 2022) Department of the Treasury Internal Revenue Service

S Corporation Shareholder Stock and Debt Basis Limitations

Attach to your tax return.
Go to *www.irs.gov/Form7203* for instructions and the latest information.

OMB No. 1545-2302
Attachment Sequence No. **203**

Name of shareholder	Identifying number
Sam Iam	***-**-0987
A Name of S corporation	**B** Employer identification number
Alpha Corporation	12-3456789

C Stock block (see instructions):

D Check applicable box(es) to indicate how stock was acquired:
(1) ☒ Original shareholder **(2)** ☐ Purchased **(3)** ☐ Inherited **(4)** ☐ Gift **(5)** ☐ Other:

E Check if you have a Regulations section 1.1367-1(g) election in effect during the tax year for this S corporation ☐

Part I Shareholder Stock Basis

1	Stock basis at the beginning of the corporation's tax year			1	0
2	Basis from any capital contributions made or additional stock acquired during the tax year			2	2,000
3a	Ordinary business income (enter losses in Part III)	3a			
b	Net rental real estate income (enter losses in Part III)	3b			
c	Other net rental income (enter losses in Part III)	3c			
d	Interest income	3d			
e	Ordinary dividends	3e			
f	Royalties	3f			
g	Net capital gains (enter losses in Part III)	3g			
h	Net section 1231 gain (enter losses in Part III)	3h			
i	Other income (enter losses in Part III)	3i			
j	Excess depletion adjustment	3j			
k	Tax-exempt income	3k			
l	Recapture of business credits	3l			
m	Other items that increase stock basis	3m			
4	Add lines 3a through 3m			4	
5	Stock basis before distributions. Add lines 1, 2, and 4			5	2,000
6	Distributions (excluding dividend distributions)			6	
	Note: If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.				
7	Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15			7	2,000
8a	Nondeductible expenses	8a			
b	Depletion for oil and gas	8b			
c	Business credits (sections 50(c)(1) and (5))	8c			
9	Add lines 8a through 8c			9	
10	Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15			10	2,000
11	Allowable loss and deduction items. Enter the amount from line 47, column (c)			11	1,728
12	Debt basis restoration (see net increase in instructions for line 23)			12	
13	Other items that decrease stock basis			13	
14	Add lines 11, 12, and 13			14	1,728
15	**Stock basis at the end of the corporation's tax year.** Subtract line 14 from line 10. If the result is zero or less, enter -0-			15	272

Part II Shareholder Debt Basis

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Separately and Nonseparately Stated Items (line 3). The series of separately and nonseparately stated items on line 3 reflect income information that appears on Schedule K-1 (Form 1120-S). Only positive amounts should appear on lines 3a through 3m, because negative amounts are reported in part III. The following items are listed on line 3.

- Ordinary business income (comes from Schedule K-1, box 1)
- Net rental real estate income (comes from Schedule K-1, box 2)
- Other net rental income (comes from Schedule K-1, box 3)
- Interest income (comes from Schedule K-1, box 4)
- Ordinary dividends (comes from Schedule K-1, box 5a)
- Royalties (comes from Schedule K-1, box 6)
- Net capital gains (comes from Schedule K-1, boxes 7 and 8a)
- Net §1231 gain (comes from Schedule K-1, box 9)
- Other income[96] (comes from Schedule K-1, box 10)
- Excess depletion adjustment (this is the amount by which the cumulative depletion deduction exceeds the proportionate share of basis in the property subject to depletion, **not** the actual depletion amount)[97] (comes from Schedule K-1, box 15, code C)
- Tax-exempt income (includes both tax-exempt interest income and other tax-exempt income) (comes from Schedule K-1, box 16, codes A and B)
- Recapture of business credits (see chart that follows)
- Other items that increase stock basis

S corporations may be required to recapture certain business credits, which can create taxable income, as well as increase basis. Line 3l includes recapture from the following credits, as denoted on Schedule K-1 with the following codes.[98]

Credit	Code for box 16 of Schedule K-1
Recapture of low-income housing credit through investments in partnerships subject to IRC §42(j)(5)	E
Recapture of low-income housing credit through investments in partnerships **not** subject to §42(j)(5)	F
Recapture of investment credit	G
Recapture of other credits, such as: • New markets credit • Indian employment credit • Credit for employer-provided childcare facilities and services • Alternative motor vehicle credit • Alternative fuel vehicle refueling property credit • Qualified plug-in electric motor vehicle credit	H

96. The instructions specifically refer to subpart F inclusion under IRC §959(a)(2), which relates to excluding previously taxed earnings. Discussion of subpart F is beyond the scope of this chapter.

97. See IRC §613.

98. 2022 Instructions for Schedule K-1 (Form 1120-S), p. 14.

Distributions (line 6). Generally, taxpayers report the distributions they receive from their S corporations on this line, as reported on Schedule K-1 (Form 1120-S) in box 16 with code D. Distributions that reduce basis are reported here because they are not included in the income of the shareholder; this is a specific requirement provided in the Code.[99] However, distributions from S corporations are included in a shareholder's income if they are made despite the shareholder's stock basis being $0.[100] In this event, the distribution is not reported on Form 7203, line 6. Instead, it is reported on the shareholder's Form 8949, *Sales and Other Dispositions of Capital Assets,* and then on Schedule D.[101] The amounts are not reported on line 6 because they are reported on Schedule D. They do not increase the stock basis for the amount of the capital gain distribution.

Example 5. Use the same facts as **Example 4,** except that Sam receives a $500 distribution on December 15, 2022, which reduces his stock basis to $1,500. The first $1,500 of the $1,728 loss reduces Sam's stock basis to $0. The remaining $228 ($1,728 loss – $1,500 remaining basis) is suspended and carried forward. This information is reported on the following Form 7203.

Form **7203** (Rev. December 2022) Department of the Treasury Internal Revenue Service

S Corporation Shareholder Stock and Debt Basis Limitations

Attach to your tax return.
Go to *www.irs.gov/Form7203* for instructions and the latest information.

OMB No. 1545-2302 Attachment Sequence No. **203**

Name of shareholder: **Sam Iam** | Identifying number: *****-**-0987**

A Name of S corporation: **Alpha Corporation** | B Employer identification number: **12-3456789**

C Stock block (see instructions):

D Check applicable box(es) to indicate how stock was acquired:
(1) ☒ Original shareholder (2) ☐ Purchased (3) ☐ Inherited (4) ☐ Gift (5) ☐ Other:

E Check if you have a Regulations section 1.1367-1(g) election in effect during the tax year for this S corporation ☐

Part I Shareholder Stock Basis

1	Stock basis at the beginning of the corporation's tax year			1	0
2	Basis from any capital contributions made or additional stock acquired during the tax year			2	2,000
3a	Ordinary business income (enter losses in Part III)	3a			
b	Net rental real estate income (enter losses in Part III)	3b			
c	Other net rental income (enter losses in Part III)	3c			
d	Interest income	3d			
e	Ordinary dividends	3e			
f	Royalties	3f			
g	Net capital gains (enter losses in Part III)	3g			
h	Net section 1231 gain (enter losses in Part III)	3h			
i	Other income (enter losses in Part III)	3i			
j	Excess depletion adjustment	3j			
k	Tax-exempt income	3k			
l	Recapture of business credits	3l			
m	Other items that increase stock basis	3m			
4	Add lines 3a through 3m			4	
5	Stock basis before distributions. Add lines 1, 2, and 4			5	2,000
6	Distributions (excluding dividend distributions)			6	500
	Note: If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.				
7	Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15			7	1,500
8a	Nondeductible expenses	8a			
b	Depletion for oil and gas	8b			
c	Business credits (sections 50(c)(1) and (5))	8c			
9	Add lines 8a through 8c			9	
10	Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15			10	1,500
11	Allowable loss and deduction items. Enter the amount from line 47, column (c)			11	1,500
12	Debt basis restoration (see net increase in instructions for line 23)			12	
13	Other items that decrease stock basis			13	
14	Add lines 11, 12, and 13			14	1,500
15	**Stock basis at the end of the corporation's tax year.** Subtract line 14 from line 10. If the result is zero or less, enter -0-			15	0

Part II Shareholder Debt Basis

99. IRC §1367(a)(2)(A).

100. IRC §1368(b)(2).

101. 2022 Instructions for Form 7203, p. 3.

Example 6. Use the same facts as **Example 5,** except rather than a loss in 2022, Alpha has operating income of $2,500. It also has a capital gain of $1,000, and Sam takes a distribution of $6,200, of which $700 is taxable as a capital gain. Sam reports this on the following Form 7203.

Form **7203** (Rev. December 2022) Department of the Treasury Internal Revenue Service

S Corporation Shareholder Stock and Debt Basis Limitations

Attach to your tax return.
Go to *www.irs.gov/Form7203* for instructions and the latest information.

OMB No. 1545-2302
Attachment Sequence No. **203**

Name of shareholder: **Sam Iam** | Identifying number: *****-**-0987**

A Name of S corporation: **Alpha Corporation** | **B** Employer identification number: **12-3456789**

C Stock block (see instructions):

D Check applicable box(es) to indicate how stock was acquired:
(1) ☒ Original shareholder **(2)** ☐ Purchased **(3)** ☐ Inherited **(4)** ☐ Gift **(5)** ☐ Other:

E Check if you have a Regulations section 1.1367-1(g) election in effect during the tax year for this S corporation ☐

Part I Shareholder Stock Basis

1	Stock basis at the beginning of the corporation's tax year			1	0
2	Basis from any capital contributions made or additional stock acquired during the tax year			2	2,000
3a	Ordinary business income (enter losses in Part III)	3a	2,500		
b	Net rental real estate income (enter losses in Part III)	3b			
c	Other net rental income (enter losses in Part III)	3c			
d	Interest income	3d			
e	Ordinary dividends	3e			
f	Royalties	3f			
g	Net capital gains (enter losses in Part III)	3g	1,000		
h	Net section 1231 gain (enter losses in Part III)	3h			
i	Other income (enter losses in Part III)	3i			
j	Excess depletion adjustment	3j			
k	Tax-exempt income	3k			
l	Recapture of business credits	3l			
m	Other items that increase stock basis	3m			
4	Add lines 3a through 3m			4	3,500
5	Stock basis before distributions. Add lines 1, 2, and 4			5	5,500
6	Distributions (excluding dividend distributions)			6	6,200
	Note: If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.				
7	Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15			7	0
8a	Nondeductible expenses	8a			
b	Depletion for oil and gas	8b			
c	Business credits (sections 50(c)(1) and (5))	8c			
9	Add lines 8a through 8c			9	
10	Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15			10	
11	Allowable loss and deduction items. Enter the amount from line 47, column (c)			11	
12	Debt basis restoration (see net increase in instructions for line 23)			12	
13	Other items that decrease stock basis			13	
14	Add lines 11, 12, and 13			14	
15	**Stock basis at the end of the corporation's tax year.** Subtract line 14 from line 10. If the result is zero or less, enter -0-			15	0

Part II Shareholder Debt Basis

Nondeductible Expenses (line 8a). Nondeductible expenses generally reduce stock basis. If a shareholder has insufficient stock basis to absorb these expenses, they reduce debt basis instead.[102] Common nondeductible expenses include meals and entertainment,[103] penalties such as parking tickets,[104] contributions to political campaigns,[105] and the portion of business gifts that exceed $25 per person.[106]

102. IRC §1367(b)(2)(A).
103. IRC §274(a).
104. IRC §162(f)(1).
105. IRC §162(e).
106. IRC §274(b).

Example 7. Use the same facts as **Example 6,** except Alpha Corporation also paid $800 in penalties in 2022. Because Sam had a basis of $0 before accounting for the nondeductible penalties, his Form 7203 looks the same as in **Example 6.**

DEBT BASIS

A shareholder's **debt basis** is increased by any loans made by a shareholder to the corporation, less the principal portion of any repayments. Debt basis restorations also increase debt basis, but only to the extent that they are taxable. Business operating losses that exceed stock basis reduce an S corporation's debt basis, and nondeductible expenses may also reduce debt basis.

Not all shareholder debt is treated the same way. If a loan is substantiated with a formal note or written instrument, repayment may be treated as capital gain.[107] If no documentation is associated with a loan, repayment may be treated as ordinary income.[108] Ideally, shareholders adequately document all loans they make to S corporations and all subsequent repayments on these loans.

If a shareholder provides money to an S corporation as a loan, they receive debt basis for the funds provided, assuming the lender and the shareholder are the same person.[109]

Losses may reduce a shareholder's debt basis.[110] This reduction in basis does not affect the amount the S corporation owes its shareholders.[111]

If the funds are loaned directly by a person or entity that does not own stock in the S corporation, generally the shareholder does not receive debt basis associated with that loan.[112] However, if the loan is made through a disregarded entity (such as an LLC) of which the S corporation shareholder is the sole member, the loan is assumed to have originated with the shareholder.[113]

Third-Party Debt

Extending a guarantee of the loan's repayment provides no debt basis until the shareholder makes a payment to the lender under the terms of the guarantee.[114] In that event, the shareholder's debt basis increases by the amount of the payment.

Example 8. Use the same facts as **Example 4.** In 2022, Sam loans Alpha $10,000. Alpha also obtains a $50,000 loan from First National Bank (First National) to expand its operations. First National requires Sam to guarantee the loan. Alpha has no other outstanding loans in 2022. Sam's stock basis is $2,000 at the beginning of the year. Alpha reports a $30,000 loss. Sam can deduct $12,000 of the 2022 loss on his individual tax return because he has $2,000 stock basis, plus he has debt basis for loaning Alpha $10,000. The loss reduces his basis in his note receivable from Alpha to $0. Sam carries the remaining $18,000 loss forward to 2023.

Sam reports his activity on the following Form 7203.

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107. Instructions for Form 7203; Treas. Reg. §1.1367-2(a)(1).

108. Treas. Reg. §1.1367-2(a)(2).

109. Treas. Reg. §1.1366-2(a)(2)(i), referencing Treas. Reg. §1.1011-1.

110. IRC §1367(b)(2).

111. IRC §1361(c)(5)(B).

112. Rev. Rul. 70-50, 1970-1 CB 178, referencing *Perry v. Comm'r*, 47 TC 159 (1966), *aff'd* 392 F.2d 458 (8th Cir. 1968).

113. Treas. Reg. §1.1366-2(a)(2)(iii), Example 1.

114. Treas. Reg. §1.1366-2(a)(2)(ii).

For Example 8

Form **7203** (Rev. December 2022) Department of the Treasury Internal Revenue Service

S Corporation Shareholder Stock and Debt Basis Limitations

Attach to your tax return.
Go to *www.irs.gov/Form7203* for instructions and the latest information.

OMB No. 1545-2302
Attachment Sequence No. **203**

Name of shareholder	Identifying number
Sam Iam	***-**-0987
A Name of S corporation	**B** Employer identification number
Alpha Corporation	12-3456789

C Stock block (see instructions):
D Check applicable box(es) to indicate how stock was acquired:
(1) ☒ Original shareholder **(2)** ☐ Purchased **(3)** ☐ Inherited **(4)** ☐ Gift **(5)** ☐ Other:
E Check if you have a Regulations section 1.1367-1(g) election in effect during the tax year for this S corporation . . . . . . ☐

Part I Shareholder Stock Basis

1	Stock basis at the beginning of the corporation's tax year			1	0
2	Basis from any capital contributions made or additional stock acquired during the tax year			2	2,000
3a	Ordinary business income (enter losses in Part III)	3a			
b	Net rental real estate income (enter losses in Part III)	3b			
c	Other net rental income (enter losses in Part III)	3c			
d	Interest income	3d			
e	Ordinary dividends	3e			
f	Royalties	3f			
g	Net capital gains (enter losses in Part III)	3g			
h	Net section 1231 gain (enter losses in Part III)	3h			
i	Other income (enter losses in Part III)	3i			
j	Excess depletion adjustment	3j			
k	Tax-exempt income	3k			
l	Recapture of business credits	3l			
m	Other items that increase stock basis	3m			
4	Add lines 3a through 3m			4	
5	Stock basis before distributions. Add lines 1, 2, and 4			5	2,000
6	Distributions (excluding dividend distributions)			6	
	Note: If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.				
7	Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15			7	2,000
8a	Nondeductible expenses	8a			
b	Depletion for oil and gas	8b			
c	Business credits (sections 50(c)(1) and (5))	8c			
9	Add lines 8a through 8c			9	
10	Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15			10	2,000
11	Allowable loss and deduction items. Enter the amount from line 47, column (c)			11	2,000
12	Debt basis restoration (see net increase in instructions for line 23)			12	
13	Other items that decrease stock basis			13	
14	Add lines 11, 12, and 13			14	2,000
15	**Stock basis at the end of the corporation's tax year.** Subtract line 14 from line 10. If the result is zero or less, enter -0-			15	0

Part II Shareholder Debt Basis

Section A—Amount of Debt (If more than three debts, see instructions.)

	Description	**(a)** Debt 1 ☒ Formal note ☐ Open account	**(b)** Debt 2 ☐ Formal note ☐ Open account	**(c)** Debt 3 ☐ Formal note ☐ Open account	**(d)** Total
16	Loan balance at the beginning of the corporation's tax year				
17	Additional loans (see instructions)	10,000			10,000
18	Loan balance before repayment. Add lines 16 and 17	10,000			10,000
19	Principal portion of debt repayment (this line doesn't include interest)				
20	Loan balance at the end of the corporation's tax year. Subtract line 19 from line 18	10,000			10,000

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For Example 8

Form 7203 (Rev. 12-2022) Page **2**

Part II **Shareholder Debt Basis** *(continued)*

Section B—Adjustments to Debt Basis

	Description	(a) Debt 1	(b) Debt 2	(c) Debt 3	(d) Total
21	Debt basis at the beginning of the corporation's tax year				
22	Enter the amount, if any, from line 17	10,000			10,000
23	Debt basis restoration (see instructions)				
24	Debt basis before repayment. Add lines 21, 22, and 23	10,000			10,000
25	Divide line 24 by line 18	1.0000			
26	Nontaxable debt repayment. Multiply line 25 by line 19				
27	Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24	10,000			10,000
28	Nondeductible expenses and oil and gas depletion deductions in excess of stock basis				
29	Debt basis before losses and deductions. Subtract line 28 from line 27. If the result is zero or less, enter -0-	10,000			10,000
30	Allowable losses in excess of stock basis. Enter the amount from line 47, column (d)	10,000			10,000
31	**Debt basis at the end of the corporation's tax year.** Subtract line 30 from line 29. If the result is zero or less, enter -0-				

Section C—Gain on Loan Repayment

	Description	(a) Debt 1	(b) Debt 2	(c) Debt 3	(d) Total
32	Repayment. Enter the amount from line 19				
33	Nontaxable repayments. Enter the amount from line 26				
34	**Reportable gain.** Subtract line 33 from line 32				

Part III **Shareholder Allowable Loss and Deduction Items**

	Description	(a) Current year losses and deductions	(b) Carryover amounts (column (e)) from the previous year	(c) Allowable loss from stock basis	(d) Allowable loss from debt basis	(e) Carryover amounts
35	Ordinary business loss					
36	Net rental real estate loss					
37	Other net rental loss					
38	Net capital loss					
39	Net section 1231 loss					
40	Other loss					
41	Section 179 deductions					
42	Charitable contributions					
43	Investment interest expense					
44	Section 59(e)(2) expenditures					
45	Other deductions					
46	Foreign taxes paid or accrued					
47	**Total loss.** Add lines 35 through 46 for each column. Enter the total loss in column (c) on line 11 and enter the total loss in column (d) on line 30					

Form **7203** (Rev. 12-2022)

Example 9. Use the same facts as **Example 8,** except that First National requires Sam to personally pay $5,000 on the bank loan to keep it from going into default. This payment is treated as a loan from Sam to Alpha, increasing his debt basis by $5,000, which enables him to deduct a $17,000 loss in 2022 ($2,000 loss from stock basis + $15,000 loss from debt basis). Sam's activities are reported on the following Form 7203.

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For Example 9

Form **7203** (Rev. December 2022) Department of the Treasury Internal Revenue Service

S Corporation Shareholder Stock and Debt Basis Limitations

Attach to your tax return.
Go to *www.irs.gov/Form7203* for instructions and the latest information.

OMB No. 1545-2302
Attachment Sequence No. **203**

Name of shareholder	Identifying number
Sam Iam	***-**-0987
A Name of S corporation	**B** Employer identification number
Alpha Corporation	12-3456789

C Stock block (see instructions):

D Check applicable box(es) to indicate how stock was acquired:
(1) ☐ Original shareholder **(2)** ☐ Purchased **(3)** ☐ Inherited **(4)** ☐ Gift **(5)** ☐ Other:

E Check if you have a Regulations section 1.1367-1(g) election in effect during the tax year for this S corporation . . . . . . ☐

Part I Shareholder Stock Basis

1	Stock basis at the beginning of the corporation's tax year			1	0
2	Basis from any capital contributions made or additional stock acquired during the tax year			2	2,000
3a	Ordinary business income (enter losses in Part III)	3a			
b	Net rental real estate income (enter losses in Part III)	3b			
c	Other net rental income (enter losses in Part III)	3c			
d	Interest income	3d			
e	Ordinary dividends	3e			
f	Royalties	3f			
g	Net capital gains (enter losses in Part III)	3g			
h	Net section 1231 gain (enter losses in Part III)	3h			
i	Other income (enter losses in Part III)	3i			
j	Excess depletion adjustment	3j			
k	Tax-exempt income	3k			
l	Recapture of business credits	3l			
m	Other items that increase stock basis	3m			
4	Add lines 3a through 3m			4	
5	Stock basis before distributions. Add lines 1, 2, and 4			5	2,000
6	Distributions (excluding dividend distributions)			6	
	Note: If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.				
7	Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15			7	2,000
8a	Nondeductible expenses	8a			
b	Depletion for oil and gas	8b			
c	Business credits (sections 50(c)(1) and (5))	8c			
9	Add lines 8a through 8c			9	
10	Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15			10	2,000
11	Allowable loss and deduction items. Enter the amount from line 47, column (c)			11	2,000
12	Debt basis restoration (see net increase in instructions for line 23)			12	
13	Other items that decrease stock basis			13	
14	Add lines 11, 12, and 13			14	2,000
15	**Stock basis at the end of the corporation's tax year.** Subtract line 14 from line 10. If the result is zero or less, enter -0-			15	0

Part II Shareholder Debt Basis

Section A—Amount of Debt (If more than three debts, see instructions.)

	Description	**(a)** Debt 1 ☒ Formal note ☐ Open account	**(b)** Debt 2 ☒ Formal note ☐ Open account	**(c)** Debt 3 ☐ Formal note ☐ Open account	**(d)** Total
16	Loan balance at the beginning of the corporation's tax year				
17	Additional loans (see instructions)	10,000	5,000		15,000
18	Loan balance before repayment. Add lines 16 and 17	10,000	5,000		15,000
19	Principal portion of debt repayment (this line doesn't include interest)				
20	Loan balance at the end of the corporation's tax year. Subtract line 19 from line 18	10,000	5,000		15,000

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For Example 9

Form 7203 (Rev. 12-2022) Page **2**

Part II **Shareholder Debt Basis** *(continued)*

Section B—Adjustments to Debt Basis

	Description	(a) Debt 1	(b) Debt 2	(c) Debt 3	(d) Total
21	Debt basis at the beginning of the corporation's tax year				
22	Enter the amount, if any, from line 17	**15,000**			**15,000**
23	Debt basis restoration (see instructions)				
24	Debt basis before repayment. Add lines 21, 22, and 23	**15,000**			**15,000**
25	Divide line 24 by line 18	**1.0000**			
26	Nontaxable debt repayment. Multiply line 25 by line 19				
27	Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24	**15,000**			**15,000**
28	Nondeductible expenses and oil and gas depletion deductions in excess of stock basis				
29	Debt basis before losses and deductions. Subtract line 28 from line 27. If the result is zero or less, enter -0-	**15,000**			**15,000**
30	Allowable losses in excess of stock basis. Enter the amount from line 47, column (d)	**15,000**			**15,000**
31	**Debt basis at the end of the corporation's tax year.** Subtract line 30 from line 29. If the result is zero or less, enter -0-				

Section C—Gain on Loan Repayment

	Description	(a) Debt 1	(b) Debt 2	(c) Debt 3	(d) Total
32	Repayment. Enter the amount from line 19				
33	Nontaxable repayments. Enter the amount from line 26				
34	**Reportable gain.** Subtract line 33 from line 32				

Part III **Shareholder Allowable Loss and Deduction Items**

	Description	(a) Current year losses and deductions	(b) Carryover amounts (column (e)) from the previous year	(c) Allowable loss from stock basis	(d) Allowable loss from debt basis	(e) Carryover amounts
35	Ordinary business loss					
36	Net rental real estate loss					
37	Other net rental loss					
38	Net capital loss					
39	Net section 1231 loss					
40	Other loss					
41	Section 179 deductions					
42	Charitable contributions					
43	Investment interest expense					
44	Section 59(e)(2) expenditures					
45	Other deductions					
46	Foreign taxes paid or accrued					
47	**Total loss.** Add lines 35 through 46 for each column. Enter the total loss in column (c) on line 11 and enter the total loss in column (d) on line 30					

Form **7203** (Rev. 12-2022)

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Open Account Advances of $25,000 or Less[115]

Open account debt does not have any document associated with the loan. If the balance of open account debt owed to a single shareholder at the end of the S corporation's tax year is $25,000 or less, they are collectively treated as a single loan. If there are any repayments during the year, they are netted against advances made to the S corporation.[116] The reduction in the shareholder's debt basis is accordingly restored.[117] Loan repayments on reduced-basis open account debt create **ordinary income** for the shareholder.[118]

Open Account Advances of More than $25,000[119]

The situation changes when an S corporation closes a tax year with more than $25,000 of open account debt outstanding to a single shareholder. Beginning the next tax year, the ability to treat all open account debt as a single liability ceases for that shareholder. The $25,000 threshold that applies to each shareholder is not applied at the entity level. A debt that exceeds $25,000 at the end of the prior year is treated as a formal note for purposes of calculating the gain on loan repayment.

Indebtedness Evidenced by Written Instrument

When an S corporation's indebtedness to one of its shareholders is documented properly, the document makes the arrangement a security eligible for capital gain treatment.[120] If repayments result in a capital gain more than one year after the loan was taken out, the gain is considered a LTCG.[121]

Although the Code has not defined what qualifies as proper documentation for a written instrument, the **straight debt guidelines** of IRC §1361(c)(5) are a good rule for any S corporation indebtedness. By using the straight debt safe harbor provisions, it maximizes the likelihood that the IRS does not determine that the indebtedness is a second class of stock.[122] This determination would put the entity in violation of one of the requirements to be an S corporation,[123] thereby risking revocation of its S corporation status.

To qualify for the straight debt safe harbor, straight debt is any **written unconditional promise** to repay the loan if **all three** of the following conditions are met.[124]

- The interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors. Fluctuations tied to the prime rate are acceptable.[125]
- There is no convertibility (directly or indirectly) into stock.
- The creditor is an individual, an estate, or a trust eligible to hold S corporation shares.[126]

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115. Treas. Reg. §1.1367-2(a)(2).
116. Treas. Reg. §1.1367-2(d)(2)(i).
117. Ibid.
118. Rev. Rul. 68-537, 1968-2 CB 372.
119. Treas. Reg. §1.1367-2(a)(2)(ii).
120. IRC §1221(a). The note must arise from the shareholder's loan to the S corporation, not from their providing services to the S corporation.
121. IRC §1222(4).
122. IRC §1361(c)(5)(A).
123. IRC §1361(b)(D).
124. IRC §1361(c)(5).
125. Ltr. Rul. 9342019 (Jul. 21, 1993).
126. IRC §1361(c)(2). A trust meeting this qualification is identified as a qualified subchapter S trust or QSST.

Gift Loans and Imputed Interest

Some debt instruments may not have a stated rate of interest. If a loan incurs interest at a below-market rate, it is a **gift loan.**[127] When more than $10,000 has been loaned to an S corporation as a gift loan, the shareholder is responsible for reporting imputed interest as taxable income.[128] The minimum interest is based on the applicable federal rate (AFR) that the IRS publishes monthly.[129] In applying AFRs to a written instrument having no stated interest rate, taxpayers should look for the term most closely matching the repayment schedule on the written instrument.[130]

This provision may affect some situations in which a shareholder sells property to an S corporation. If the shareholder-seller takes a note, that note should carry an interest rate of at least as much as the AFR for the loan term.[131]

Multiple Debts[132]

When a shareholder has multiple debts to an S corporation at the end of the S corporation's tax year, the reduction in basis is applied to each debt in the same proportion that the debt basis has in relation to the aggregate bases of all the shareholder's debt.

Example 10. Use same facts as **Example 4.** Sam purchases $2,000 worth of Alpha's common stock on January 2, 2022. On the same day, he loans Alpha $10,000 under a promissory note that qualified as a written instrument (debt #1).

During 2022, Alpha incurs an ordinary business loss of $22,000, along with a $2,000 §179 expense deduction. As a result, Sam has a $0 basis in Alpha stock ($2,000 capital stock acquired – $2,000 maximum loss to be applied to the stock basis). Sam's basis in the debt he loans to Alpha is reduced to $0 ($10,000 loan – $10,000 ordinary business loss for 2022). Sam has a $10,000 suspended loss and $2,000 suspended §179 carryover to 2023.

On July 15, 2023, Sam loans Alpha $30,000 (debt #2). There is no separate loan document supporting debt #2, and, therefore, debt #2 is treated as open account indebtedness. During 2023, Alpha sustains another loss of $9,000. Sam's stock basis in the corporation is still $0. His basis in debt #1 is still $0, and his basis in debt #2 is $9,000 ($30,000 loan – $21,000 ($10,000 carryover + $2,000 §179 carryover + $9,000 current year loss)).

Even though Sam's loans have a combined principal amount of $40,000, Sam has $0 basis in debt #1 and $9,000 of debt basis in debt #2. Sam's 2023 Form 7203, part II, section A, follows.

zero or less, enter -0- . . . . 15 | 0

Part II **Shareholder Debt Basis**

Section A—Amount of Debt (If more than three debts, see instructions.)

	Description	**(a)** Debt 1 ☒ Formal note ☐ Open account	**(b)** Debt 2 ☐ Formal note ☒ Open account	**(c)** Debt 3 ☐ Formal note ☐ Open account	**(d)** Total
16	Loan balance at the beginning of the corporation's tax year	**10,000**	**0**		**10,000**
17	Additional loans (see instructions)	**0**	**30,000**		**30,000**
18	Loan balance before repayment. Add lines 16 and 17	**10,000**	**30,000**		**40,000**
19	Principal portion of debt repayment (this line doesn't include interest)		**0**		
20	Loan balance at the end of the corporation's tax year. Subtract line 19 from line 18	**10,000**	**30,000**		**40,000**

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127. IRC §7872(c)(1).

128. IRC §7872(c)(3).

129. For example, Rev. Rul. 2023-13, 2023-32 IRB 1, published the AFRs for August 2023.

130. IRC §1274(d)(1)(A).

131. IRC §483(b).

132. Treas. Reg. §1.1367-2(b)(3).

Order of Debt Basis Restoration[133]

After an S corporation shareholder incurs a debt basis reduction, their debt basis can be restored if there is a **net increase.**[134] A net increase is generally the amount that the income items collectively exceed losses, deductions, nondeductible expenses, some oil and gas depletion deductions, and certain nondividend distributions (discussed previously). These amounts are used to restore the taxpayer's debt basis in the S corporation before their stock basis.[135]

The net increase is figured as follows.[136]

	Sum of all increases to basis (line 4)
–	Distributions (line 6)
–	Sum of all nondeductible expenses (line 9)
–	Other items that decrease basis (line 13, as applicable)
–	Current year losses and deductions (line 47(a))
–	Carryover amounts from the previous year (line 47(b))
	Net increase

If the net increase exceeds the total reduction in debt basis (line 16 minus line 21), then the restoration is limited to the amount needed to restore debt basis to the face of the loan.

Repayment Restores Reduced Debt Basis First.[137] When a shareholder's basis in debt has been reduced, they apply any net increase first to restore their basis in any debt that was repaid during the tax year. Only after the basis of each outstanding shareholder debt is restored can the shareholder restore their stock basis.

Debt basis restoration may restore the basis of more than one debt. Treasury regulations give priority to any debt restoration that may result in a gain, which may benefit the shareholders.

Proportionate Restoration of Basis on Remaining Outstanding Debts.[138] If a shareholder has more than one debt, any net increase first restores the basis reduction associated with any loans that have been repaid. After restoring the debt basis of the repaid loans, the remaining net increase restores the shareholder's basis in each loan proportionately. The proportion is determined by the remaining basis reduction that each outstanding debt incurred at the beginning of the tax year. After considering the repayment of any debt, the remaining basis reduction is apportioned to all debts having reduced basis. The basis restoration allocated to each debt is based on the remaining reduction of debt basis.

Part II, Section A — Shareholder Debt Basis

A shareholder may extend multiple loans to an S corporation in which they have an interest, possibly with multiple written debt instruments. Generally, open account debt is consolidated into a single debt, while debts with separate formal notes are listed in separate columns in Form 7203, part II, section A.

Part II is divided into three sections, with section A determining the **amount of debt** the S corporation owes the shareholder at the end of the corporation's tax year.

133. Treas. Reg. §1.1367-2(c).
134. IRC §1367(b)(2)(B); Treas. Reg. §1.1367-2(c)(1).
135. IRC §1367(b)(2)(B).
136. Instructions for Form 7203.
137. Treas. Reg. §1.1367-2(c)(1).
138. Treas. Reg. §1.1367-2(c)(2).

A formal promissory note may document a shareholder's loan to an S corporation. In this circumstance, the shareholder should mark the "Formal note" checkbox above line 16. Taxpayers should mark "Formal note" if, at the end of the previous year, the S corporation owed the shareholder more than $25,000 on open account indebtedness. They should also mark this checkbox if the shareholder is owed $25,000 or less in current open account indebtedness, but was owed more than $25,000 at the end of **any** prior year.

Alternatively, the S corporation may owe open-account indebtedness to a single shareholder that nets out to $25,000 or less and has never been more than $25,000. In this circumstance, the shareholder should mark the "Open account" checkbox.

A shareholder with more than three debts at the beginning of the year should report any additional advances under a specific loan on line 17. Conversely, principal repayments to a shareholder under a specific loan should appear on line 19. Some or all of this amount may represent a capital gain to the shareholder, depending on the shareholder's debt basis, as discussed later with section B. Line 20, the final line of part II, includes the loan balance at the end of the corporation's tax year.

If a shareholder has extended more than three loans to the S corporation, they should file another Form 7203 with their return.

Part II, Section B — Adjustments to Debt Basis

As discussed previously, a shareholder's allocation of an S corporation's operating losses or deductions may reduce their basis in any debt owed to them. Its operating income or tax-exempt income may subsequently restore it. Part II, section B, of Form 7203 itemizes these adjustments.

Beginning Debt Basis (line 21). This amount is the end-of-year basis for the debt, as reported on line 31 of the prior year Form 7203. A shareholder who advances additional amounts under a loan reports these amounts on line 22, as they did on line 17 of section A. When line 16 exceeds line 21, debt basis has been used to allow losses.[139]

Current Year Debt Basis Restoration (line 23). If a shareholder reduced their debt basis in prior years, they report any current-year restoration on line 23. However, no restoration occurs unless one of the following has taken place.[140]

- The S corporation generates positive income.
- The S corporation has tax-exempt income.
- The S corporation has an excess depletion adjustment.

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Debt Basis Restoration with Multiple Debts.[141] When an S corporation has multiple debt obligations to the shareholder, shareholders first apply the debt basis restoration to a debt repaid during the tax year.

> **Note.** The objective of the debt basis restoration is to minimize capital gains during the tax year associated with that debt repayment. However, it may not eliminate them, even if the debt basis restoration is greater than the principal repayment.

Fraction of Debt Basis Not Reduced (line 25). By dividing debt basis before repayment (line 24) by the loan balance before repayment (line 18), a shareholder calculates the fraction of the debt basis that has not been reduced.[142]

Nontaxable Debt Repayment (line 26). Line 26 reflects what amount of the repaid principal on the debt is a nontaxable principal repayment. A shareholder generally owes no tax on this amount, as it appears later on line 33. The nontaxable debt repayment amount reduces the shareholder's debt basis.

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139. See Treas. Reg. §1.1367-2(c)(1), sentence that indicates the rules apply only to debt held by shareholder at the beginning of the tax year.

140. IRC §1367(b)(2); Treas. Reg. §1.1367-2(c).

141. Treas. Reg. §1.1367-2(c)(2).

142. Ibid.

Nondeductible Expenses (line 28). Line 28 reports a shareholder's portion of any expenses the S corporation cannot deduct from income. In general, these expenses reduce a shareholder's basis. However, they only reduce debt basis in specific circumstances.

If the shareholder has a **positive** stock basis after distributions are deducted, then nondeductible expenses are compared to line 7. If the nondeductible expenses exceed the stock basis reported on line 7, then the excess amount is reported on line 28. Any shareholder debt having a basis greater than $0 is reduced. If more than one debt has a basis greater than $0, the nondeductible expenses are apportioned.

If the shareholder reports a $0 stock basis on line 7, nondeductible expenses do not reduce the stockholder's debt basis unless they have made an election under Treas. Reg. §1.1367-1(g). This ordering rule was discussed previously.

Caution. Nondeductible expenses are also grouped with excess oil and gas depletion expenses in certain circumstances. Discussion of excess oil and gas depletion is beyond the scope of this discussion.

The resulting difference is compared with the debt basis before nondeductible expenses, line 27 and the smaller of the two numbers is reported on line 28.

Line 28 is where the election under Treas. Reg. §1.1367-1(g), as discussed previously, makes a difference. If a shareholder skips this election, no nondeductible expenses **in excess of stock and debt basis** are carried forward to the next tax year. Alternatively, if they have made this election, the smaller of the following two amounts carries forward to the next year.

- Line 13 (other items that decrease basis that are attributable to the election)
- Line 27 debt basis before nondeductible expenses

Debt Basis at the End of the Corporation's Tax Year (line 31). If any loss is allowed over stock basis, it reduces the shareholder's debt basis as shown on line 31.

Part II, Section C — Gain on Loan Repayment

Shareholders with more than one loan to an S corporation must prorate any allocated reduction to the loans based on the ratio that each loan's basis bears to the aggregate bases of the loans.[143] The character of the gain on repayment depends on whether the debt is evidenced by a formal note or is an open account. Debt evidenced by a formal note results in **capital gain,** and is reported on Form 8949 and Schedule D. Any open account debt results in **ordinary gain** and is reported on Form 4797, *Sales of Business Property.*[144]

Observation. Normally, debt repayment is not considered a taxable event.

Example 11. Use the same facts as **Example 10,** except that in 2024, Alpha has ordinary business income of $15,000, and Sam receives a repayment of $4,000 on debt #2 (formal note) to Alpha. Alpha has $100 of nondeductible expenses and also incurs a §1231 loss of $500 from the sale of equipment.

Not all of Alpha's ordinary business income is allocated to increase Sam's debt basis.

Alpha repays Sam $4,000 on debt #2 (formal note.) Alpha incurs nondeductible expenses that reduce the debt basis reduction available by $100, plus the §1231 loss of $500. Sam has $14,400 ($15,000 ordinary business income – $100 nondeductible expenses – $500 §1231 loss) available for debt basis restoration. This amount is split between debt #1 and debt #2 as shown on Sam's Form 7203 that appears next.

143. Treas. Reg. §1.1367-2(b)(3).

144. Instructions to Form 7203.

For Example 11

Form **7203** (Rev. December 2022) Department of the Treasury Internal Revenue Service

S Corporation Shareholder Stock and Debt Basis Limitations

Attach to your tax return.
Go to *www.irs.gov/Form7203* for instructions and the latest information.

OMB No. 1545-2302
Attachment Sequence No. **203**

Name of shareholder	Identifying number
Sam Iam	***-**-0987
A Name of S corporation	**B** Employer identification number
Alpha Corporation	12-3456789

C Stock block (see instructions):

D Check applicable box(es) to indicate how stock was acquired:
(1) ☐ Original shareholder **(2)** ☐ Purchased **(3)** ☐ Inherited **(4)** ☐ Gift **(5)** ☐ Other:

E Check if you have a Regulations section 1.1367-1(g) election in effect during the tax year for this S corporation . . . . . . ☐

Part I Shareholder Stock Basis

1	Stock basis at the beginning of the corporation's tax year			1	0
2	Basis from any capital contributions made or additional stock acquired during the tax year			2	
3a	Ordinary business income (enter losses in Part III)	3a	15,000		
b	Net rental real estate income (enter losses in Part III)	3b			
c	Other net rental income (enter losses in Part III)	3c			
d	Interest income	3d			
e	Ordinary dividends	3e			
f	Royalties	3f			
g	Net capital gains (enter losses in Part III)	3g			
h	Net section 1231 gain (enter losses in Part III)	3h			
i	Other income (enter losses in Part III)	3i			
j	Excess depletion adjustment	3j			
k	Tax-exempt income	3k			
l	Recapture of business credits	3l			
m	Other items that increase stock basis	3m			
4	Add lines 3a through 3m			4	15,000
5	Stock basis before distributions. Add lines 1, 2, and 4			5	15,000
6	Distributions (excluding dividend distributions)			6	
	Note: If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.				
7	Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15			7	15,000
8a	Nondeductible expenses	8a	100		
b	Depletion for oil and gas	8b			
c	Business credits (sections 50(c)(1) and (5))	8c			
9	Add lines 8a through 8c			9	100
10	Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15			10	14,900
11	Allowable loss and deduction items. Enter the amount from line 47, column (c)			11	500
12	Debt basis restoration (see net increase in instructions for line 23)			12	14,400
13	Other items that decrease stock basis			13	
14	Add lines 11, 12, and 13			14	14,900
15	**Stock basis at the end of the corporation's tax year.** Subtract line 14 from line 10. If the result is zero or less, enter -0-			15	0

Part II Shareholder Debt Basis

Section A—Amount of Debt (If more than three debts, see instructions.)

	Description	**(a)** Debt 1 ☒ Formal note ☐ Open account	**(b)** Debt 2 ☒ Formal note ☐ Open account	**(c)** Debt 3 ☐ Formal note ☐ Open account	**(d)** Total
16	Loan balance at the beginning of the corporation's tax year	10,000	30,000		40,000
17	Additional loans (see instructions)	0			
18	Loan balance before repayment. Add lines 16 and 17	10,000	30,000		40,000
19	Principal portion of debt repayment (this line doesn't include interest)		4,000		4,000
20	Loan balance at the end of the corporation's tax year. Subtract line 19 from line 18	10,000	26,000		36,000

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For Example 11

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Part II Shareholder Debt Basis *(continued)*

Section B—Adjustments to Debt Basis

	Description	(a) Debt 1	(b) Debt 2	(c) Debt 3	(d) Total
21	Debt basis at the beginning of the corporation's tax year	0	9,000		9,000
22	Enter the amount, if any, from line 17				
23	Debt basis restoration (see instructions)	3,851	10,549		14,400
24	Debt basis before repayment. Add lines 21, 22, and 23	3,851	19,549		23,400
25	Divide line 24 by line 18	0.3851	0.6516		
26	Nontaxable debt repayment. Multiply line 25 by line 19		2,607		2,607
27	Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24	3,851	16,942		20,793
28	Nondeductible expenses and oil and gas depletion deductions in excess of stock basis				
29	Debt basis before losses and deductions. Subtract line 28 from line 27. If the result is zero or less, enter -0-	3,851	16,942		20,793
30	Allowable losses in excess of stock basis. Enter the amount from line 47, column (d)				
31	**Debt basis at the end of the corporation's tax year.** Subtract line 30 from line 29. If the result is zero or less, enter -0-	3,851	16,942		20,793

Section C—Gain on Loan Repayment

	Description	(a) Debt 1	(b) Debt 2	(c) Debt 3	(d) Total
32	Repayment. Enter the amount from line 19		4,000		4,000
33	Nontaxable repayments. Enter the amount from line 26		2,607		2,607
34	**Reportable gain.** Subtract line 33 from line 32		1,393		1,393

Part III Shareholder Allowable Loss and Deduction Items

Of the $4,000 Sam received as repayment of open account debt, $2,607 is a nontaxable repayment. This amount appears on line 33 of Sam's Form 7203. The balance of the repayment, or $1,393, is taxed as capital gain because it now is classified as a formal debt. Sam reports the $1,393 gain on his Schedule D.

The following table shows Sam's allocation of debt basis restoration, as reported on line 23 of his Form 7203.

	Form 7203 Line No.	Formal Note	Open Account	Total
Loan balance before repayment	18	$10,000	$30,000	$40,000
Less: principal portion of debt repayment	19	(0)	(4,000)	(4,000)
Loan balance at yearend	20	$10,000	$26,000	$36,000
Less: debt basis at beginning of year	21	(0)	(9,000)	(9,000)
Difference		$10,000	$17,000	$27,000
		÷ $27,000	÷ $27,000	÷ $27,000
Proportion of total		37.037%	62.963%	100.000%
Total debt restoration amount after debt repayment		× $10,400	× $10,400	× $10,400
Allocation of debt basis restoration after debt repayment		$ 3,852	$ 6,548	$10,400
Debt repayment			4,000	4,000
Total allocation of debt basis restoration		$ 3,852	$10,548	$14,400

Thus, the net increase of $14,400 (line 23, column d) restores $3,852 (line 23, column a) of the basis of debt #1 and $10,548 (line 23, column b) of the basis of debt #2.

Observation. Although the first portion of the net increase restores debt basis, this does not mean that the repayment of the debt's principal is nontaxable. Line 23 presents the restoration of the debt basis, which is added to the debt basis at the beginning of the year to determine the debt basis before repayment.

Note. Even if an S corporation shareholder has a positive debt basis in loans they have extended to the corporation, distributions are still taxable if the stock basis is zero at the end of the year during which they are made.[145]

Practitioner Planning Tip

Tax practitioners should consider the possibility that any amount appearing on an S corporation shareholder's Schedule K-1 in box 16 with Code D (distributions) could cause a capital gain. The exception would be when the shareholder has a positive stock basis greater than the distribution.

Part III — Shareholder Allowable Loss and Deduction Items

Shareholders use Form 7203, part III, to determine which losses and deductions from Schedule K-1 they can use in the current year or carry over to the next year. While part II of Form 7203 is concerned with amounts associated with each debt owed to the shareholder, part III determines which losses are **allowed** and which are not.

If an S corporation sustains losses in more than one income category, the loss or deduction that exceeds the basis must be apportioned among stock basis, debt basis, and carryforward to next year.

Example 12. On December 31, 2022, George Gamma, the sole shareholder of Gamma Corporation, an established S corporation, has no stock basis in the corporation and $12,000 of debt basis. A promissory note documents the debt and meets the standards for a formal written instrument. During 2022, Gamma sustains an ordinary business loss of $11,000, a capital loss of $3,000, and a §179 expense deduction of $2,000. George's allowable losses are calculated as follows.

Debt basis		$12,000
Ordinary business loss	$11,000	
Capital loss	3,000	
§179 expense deduction	2,000	
Total losses and §179 deduction	$16,000	÷ 16,000
Allowable percentage		75%
Ordinary business loss ($11,000 × 75%)		$ 8,250
Capital loss ($3,000 × 75%)		2,250
§179 expense deduction ($2,000 × 75%)		1,500
Total allowable losses and deduction against debt basis		$12,000

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145. IRC §1368(b)(2).

The losses and the §179 expense deduction eliminate George's remaining debt basis. The $4,000 balance of expenses ($16,000 total losses – $12,000 allowable losses) is carried forward to 2023 income. If Gamma reports nondeductible expenses on George's Schedule K-1, they cannot be carried forward unless George has an election under Treas. Reg. §1.1367-1(g), as discussed previously.

The following is an excerpt from George's 2022 Form 7203.

34 Reportable g... subtract line 33 fr... 32

Part III Shareholder Allowable Loss and Deduction Items

	Description	(a) Current year losses and deductions	(b) Carryover amounts (column (e)) from the previous year	(c) Allowable loss from stock basis	(d) Allowable loss from debt basis	(e) Carryover amounts
35	Ordinary business loss	11,000			8,250	2,750
36	Net rental real estate loss					
37	Other net rental loss					
38	Net capital loss	3,000			2,250	750
39	Net section 1231 loss					
40	Other loss					
41	Section 179 deductions	2,000			1,500	500
42	Charitable contributions					
43	Investment interest expense					
44	Section 59(e)(2) expenditures					
45	Other deductions					
46	Foreign taxes paid or accrued					
47	**Total loss.** Add lines 35 through 46 for each column. Enter the total loss in column (c) on line 11 and enter the total loss in column (d) on line 30	16,000	0	0	12,000	4,000

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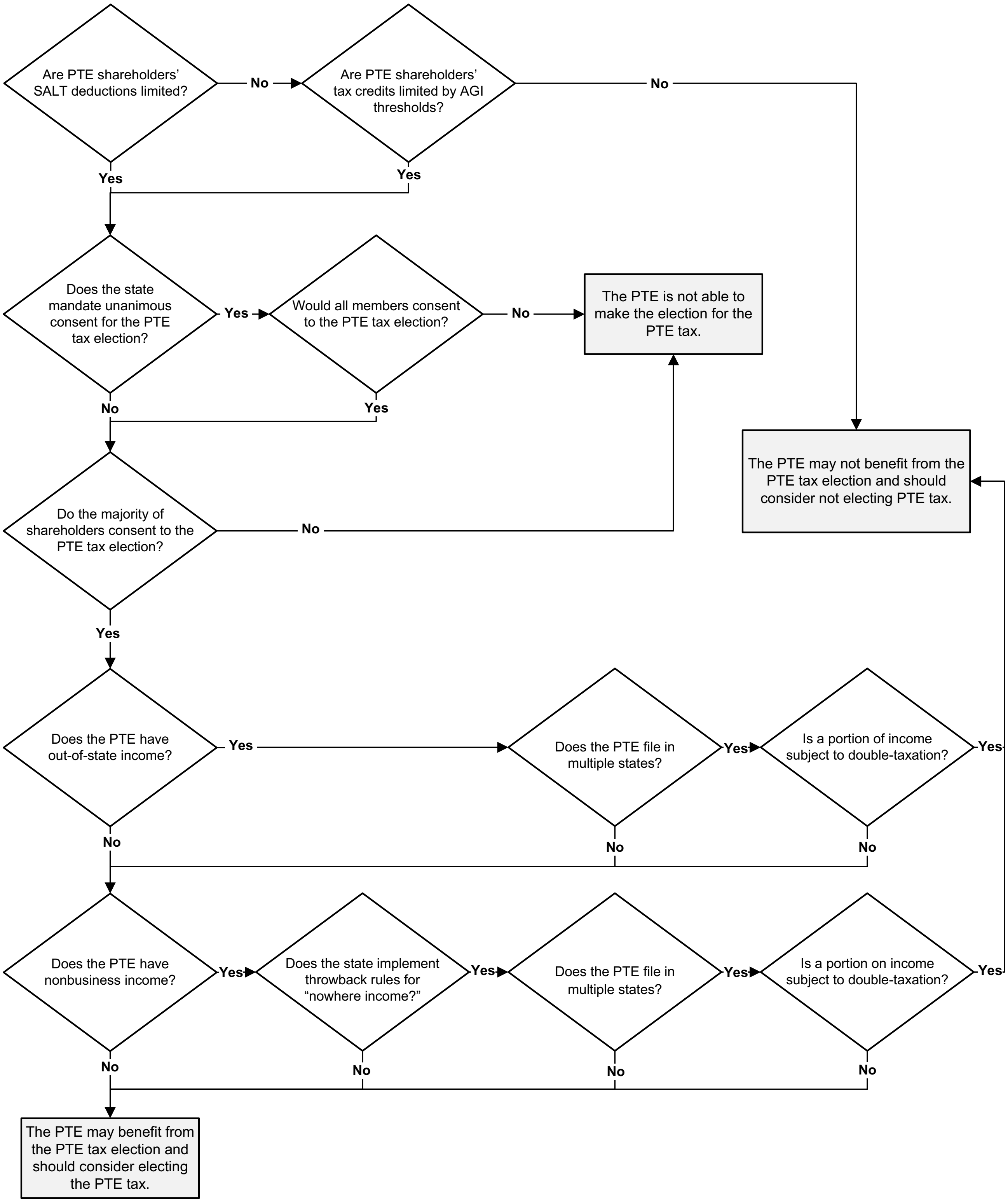
George may take $12,000 in losses, which offset his remaining debt basis. The 25% of losses George cannot use on his 2022 tax return are carried forward to 2023, as shown in column (e).

APPENDIX

QUESTIONS TO CONSIDER IN ELECTING THE PTE TAX



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LIST OF STATES WITH PTE TAX ELECTIONS AND THEIR PTE TAX RATES[146]

State	PTE Tax Rate
AL	5.00%
AR	4.90%, 2.45% on cap gains
AZ	2.98%
CA	9.30%
CO	4.40%
CT	6.99%
GA	5.75%
HI	11.00%
IA	6.00%
ID	6.00%
IL	4.95%
IN	3.23%
KS	5.70%
KY	4.50%
LA	4.25%
MA	5.00%
MI	4.25%
MD	8.00%, 8.25% if there is an entity member
MN	9.85%
MO	5.40%
MS	5.00%
MT	6.75% before 2024, 5.9% after 2023
NC	4.99%
NE	6.84% before 2023, 6.64% for 2023
NJ	5.675%–10.900%
NM	5.90%
NY	6.85%–10.90%
NYC	3.876%
OH	5.00% through 2022, 3.00% in 2023 and later
OK	5.00%
OR	9.90%, 9.00% under $250,000
RI	5.99%
SC	3.00%
UT	4.85%
VA	5.75%
WI	7.90%
WV	6.50% for 2022, 5.12% for 2023

146. *Links to States' Pass-Through Entity (PTE) Tax Legislation and Tax Authorities' Information and Guidance.* Jun. 13, 2023. AICPA. [us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-links-to-pass-through-entity-pte-taxes-states-legislation-and-tax-authorities-information-and-guidance.pdf] Accessed on Jul. 20, 2023.