Let's start with a little dose of reality: There are areas of the tax law so complex, so convoluted, that try as you might, you will never attain a mastery of the material.

You could spend the remainder of your career studying the pages of Section 263A, and still remain confounded by certain areas of the Unicap rules. Or you could invest an inordinate amount of time dissecting the partnership capital account maintenance rules of Section 704 and still feel as lost as a second-year staff.

But here's some good news: the focus of today's Tax Geek Tuesday is *not* one of these areas of the law. I believe that every tax advisor can reasonably expect to gain a full and comprehensive understanding of the importance, mechanics, and consequences of determining a shareholder's basis in his or her S corporation. This is largely due to the fact that in general, subchapter S is plainly written, and thus stands in stark contrast to the morass that is the partnership rules of subchapter K. From a more specific perspective, the authority necessary to determine a shareholder's basis in an S corporation is primarily isolated to the statute and regulations, eliminating the need for a tax adviser in search of clarity to comb through decades of administrative ruling and judicial precedent.

Let's get to it.

S Corporations, in General

In this Tax Geek Tuesday, we will spend a lot of time on what I consider the "how" of the tax law – the mechanical, formulaic rules of Sections 1366 and 1367 that instruct us when computing a shareholder's basis to add this to that, subtract that from this, and precisely when to do both. And while the "how" is important and necessary, I believe it's equally important to understand *why* we're doing what we're doing – why is the statute written in the manner that it is? Why are we adding and subtracting and following specific ordering rules when determining a shareholder's basis?

As we go embark on our deconstruction of shareholder basis, you may find that some of the rules require computations that stretch the limits of your understanding. Know this, however, the rules are written the way they are in order to preserve a key difference between C corporations and S corporations that you are likely already very familiar with – C corporation income should be subject to double taxation, while S corporation income should only be subject to a single level of taxation.

The hallmark of subchapter C is the double taxation regime. If a C corporation earns income, that income is taxed first at the entity level. Then, if the corporation distributes the income, the recipient shareholder pays tax on the income a second time as a dividend. If instead, the corporation retains the income and the value of the shareholder's stock increases, the shareholder will effectively pay tax on the income a second time in the form of capital gain upon the disposition of the stock.

S corporations, however, are intended to be subject to only a single level of taxation. Thus, when an S corporation generates income, the corporation generally does not pay tax on that income at the entity level (subject to the notable exceptions of Sections 1374 and 1375). Instead, the income is divvied up among and allocated to the corporation's shareholders, who report the income and pay the corresponding tax on their individual returns.

If the S corporation then distributes the income – or the corporation retains the income, thus increasing the value of the shareholders' stock – it is the intent of the statute that neither the distribution nor the sale of the shareholder's stock will result in the income of the S corporation being taxed a second time. This is where the basis adjustment rules of Section 1366 come in to play — they act as the mechanism by which the extremely vital preservation of the single level of taxation specific to S corporations is accomplished by ensuring that a distribution of S corporation income or sale of shareholder stock does not result in a second level of taxation.

To illustrate, assume you form an S corporation today by investing $500 in cash. Pursuant to Section 358, you will take an initial basis in the S corporation stock of $500. Assume further that in year 1, the S corporation earns $100 of income. The income is not taxed at the corporate level; rather, it is allocated to you on Schedule K-1, and you pay tax on the $100 on your Form 1040.

If the corporation retains the $100 of income, presumably the value of the stock has now increased from $500 to $600. If someone comes along and offers you $600 for the stock, and you *haven't* adjusted your original $500 basis in the stock, the sale will give rise to $100 of gain under Section 1001. The problem, of course, is that if you recognize $100 of gain on the disposition of the S corporation's stock, you will have paid tax on the same $100 earned by the corporation *twice* – once when it was earned and allocated to you, and again upon the sale of the stock.

To prevent this result, Section 1367 requires that when the S corporation allocates to you $100 of income, you must *increase* your stock basis from $500 to $600. Now, if you sell the stock for its value of $600, no further gain arises. By increasing your stock basis to account for the $100 of income earned by the corporation, you have preserved the single level of taxation that is the hallmark of subchapter S.

Reasons for Tracking Shareholder Basis

A shareholder (not the corporation!) must track his or her basis in the corporation for three reasons:

1. As reflected above, to determine gain or loss on the sale of the stock under Section 1001.
2. If the corporation allocates a loss to a shareholder, to determine the amount of the loss the shareholder may currently utilize and how much must be suspended and carried forward.
3. To determine the taxability of distributions received by the shareholder from the corporation.

Twin Concepts

Up to this point, I have been referring to a shareholder's generic basis "in the S corporation." The statute, however, provides for two distinct *types* of basis – the shareholder will hold a basis in the stock of the corporation, but also in any debt that is owed directly from the corporation back to the shareholder.

We will examine both types of basis in detail, but first, a word of warning. Of the three reasons described above for determining shareholder basis, a shareholder's debt basis is relevant only for purposes of determining the amount of loss a shareholder may currently utilize. The concept of debt basis has no bearing on determining the gain or loss on the sale of stock, nor does it impact the taxability of an S corporation's distributions. Far too often, tax advisors will make the mistake of adding additional weight to a shareholder's debt basis in situations where it is not warranted. Take heed, and understand that debt basis has but one specific purpose – to utilize losses allocated to a shareholder in excess of his or her stock basis.

Stock Basis

To determine a shareholder's basis in his S corporation stock, we must start at, well…the beginning. We do so by determining the shareholder's initial basis in the stock, a determination that will not be driven by subchapter S, but rather by other areas of the Code depending on the manner of acquisition.

For example:

- If a shareholder acquires the shares by forming the corporation, as indicated in our illustration above, the shareholder generally takes a basis in the shares equal to the cash plus the adjusted tax basis of any property contributed. (Section 358)
- If the shareholder acquires the stock via purchase, his initial basis is generally his cost under Section 1012.

- If a shareholder holds stock in a C corporation that elects S status, the shareholder's initial basis in the S corporation stock is his basis in the C corporation stock at the time of conversion. It is irrelevant whether the C corporation possessed earnings and profits, retained earnings, or a net operating loss, as those are corporate level attributes.
- Stock acquired by gift is generally the donor's basis under Section 1015.
- Stock acquired by inheritance is generally the fair market value of the stock at the date of death under Section 1014, or six months later, if the alternate valuation date is elected.

Examples:

A contributes cash of $10,000 and property with a tax basis of $7,000 and FMV of $20,000 to S Co. in exchange for all of the S Co. stock. Under Section 358, A takes a basis in the S Co. stock of $17,000, the $10,000 of cash plus the $7,000 adjusted tax basis of the contributed property.

A is a shareholder in C Co. a C corporation. On 1/1/2013, when A has a basis in the C Co. stock of $20,000, C Co. elects S status. A's initial basis in his S Co. stock is $20,000.

Once initial basis is determined, Section 1367 requires the shareholder to adjust his basis annually – or on the date of sale, if stock is sold – for items of income, gain, loss, deduction, and distribution allocated to the shareholder by the corporation. Again, the purpose of these rules is to preserve a single level of taxation.

Section 1367(a)(1) provides that a shareholder must increase the basis of his S corporation stock for the following items:

- Capital contributions
- Non-separately stated income (Schedule K-1, Line 1)
- Separately stated income (capital gain, Section 1231 gain, interest, dividends, etc…)
- Tax-exempt income, and
- The excess of the deductions for depletion over the basis of the property subject to depletion.

A quick digression: people often are confused by why basis is increased by tax-exempt income. If the reason for increasing basis is to prevent double taxation on the income earned by the S corporation, then why increase basis for tax-exempt income, which isn't even taxed once? The reason is fairly obvious – basis must be increased to preserve the tax-exempt nature of the income. If we go back to our $500 illustration, if the $100 earned by the corporation were tax-exempt state and local bond interest, and if the shareholder failed to increase his basis from $500 to $600 to account for the interest, when the shareholder sold his stock for $600 he would recognize $100 of gain, effectively converting what was intended to be $100 of tax-exempt income into taxable gain.

In addition, a shareholder must make downward adjustments to basis for the mirror images of those increases, decreasing basis for the following items:

- Distributions, other than those taxed as dividends under Section 1368,
- Non-separately stated loss
- Separately stated items of loss and deduction
- Non-deductible expenses that are not properly chargeable to a capital account, and
- The amount of the shareholder deduction for depletion to the extent such deduction does not exceed the shareholder's share of the adjusted basis of any oil and gas property held by the S corporation.

When an S corporation allocates a loss to a shareholder, Section 1366 limits the use of those losses to the extent of the shareholder's basis in the stock and debt of the corporation. Any loss in excess of a shareholder's stock and debt basis is suspended and carried forward to the next year, where it will be treated as a newly incurred loss.

Thus, of utmost importance to determining the amount of this allowable loss is the order in which the adjustments to basis are required to be made.

The regulations mandate that under the general rule, stock basis is adjusted in the following order:

- First, basis is adjusted for the required increases to basis. This takes basis to its highest possible point.
- Next, stock basis is reduced by distributions prior to any reduction for losses or nondeductible expenses.
- Next, basis is reduced for nondeductible expenses, and
- Finally, after reduction for distribution and non-deductible expenses, basis is reduced for any items of loss and deduction.

As we will discuss at the end of this analysis, Section 1368 provides that when a distribution to a shareholder exceeds the shareholder's basis in his stock, the excess generates capital gain. By requiring distributions to reduce basis before losses, the statute provides that it is more likely that a distribution will be a nontaxable return of basis, while a loss will be suspended and carried forward. This is typically a more desirous result than if the ordering rules were switched, which would generate useable losses but also current capital gain on the excess distribution.

Basis cannot be reduced below zero; to the extent losses exceed the remaining stock basis after reductions for distributions and nondeductible expenses, the excess losses can be applied to reduce any basis the shareholder has in indebtedness of the S corporation to the shareholder. To the extent the losses exceed the shareholder's basis in both stock and debt, the losses are suspended and may be carried forward indefinitely.

Example:

A owns 100% of S Co., an S corporation. A begins 2013 with a basis of $5,000 in his S. Co. stock. During 2013, S Co. generates $2,000 of ordinary income and $7,000 of long-term capital loss and makes a $5,000 distribution to A.

In adjusting stock basis for 2013, A begins by increasing his beginning basis of $5,000 to its highest point for the $2,000 of ordinary income. The adjusted basis of $7,000 is then decreased first by the $5,000 distribution, reducing A's stock basis to $2,000. A then reduces stock basis to zero for $2,000 of the $7,000 long-term capital loss. Assuming A has no basis in the indebtedness of S Co., the remaining $5,000 of long-term capital loss must be carried forward, where it will be treated as a newly incurred loss in 2014.

Change in Ordering Rules

Obviously, a shareholder would prefer to reduce basis for losses prior to non-deductible expenses, which provide no current tax benefit. The regulations allow for this result by providing an irrevocable election under Reg. Section 1.1367-1(g), which permits the shareholder to reduce basis by losses prior to reducing it for nondeductible expenses. As with all favorable elections in the Code, however, there's a catch.

Under the default ordering rules, if a shareholder's non-deductible expenses exceed his stock basis, they do not carry forward to reduce basis in a succeeding year. If, however, the shareholder elects to reverse the ordering rules, any non-deductible expenses that don't currently reduce basis will carry forward and eventually come home to roost, reducing basis in a subsequent year

Example:

On 1/1/2014, A has $10,000 of basis in his S Co. stock. During 2014, S Co. allocates to A $5,000 of income, $17,000 of non-deductible expenses, and $10,000 of losses. If A does not make the election to reverse the ordering rules of Reg. Section 1.1367-1(f), S will adjust his basis as follows:

Beginning Basis	$10,000
Income	$5,000
Non-deductible expenses	($15,000)
Ending basis	$0
C/O Losses	$10,000
C/O non-deductible expenses	$0

Alternatively, A may elect under Reg. Section 1.1367-1(g) to deduct losses before non-deductible. If the election is made, any non-deductible expenses that do not currently reduce basis must be carried over to future years, as indicated below:

Beginning Basis	$10,000
Income	$5,000
Losses	($10,000)
Non-deductible expenses	($5,000)
Ending basis	$0
C/O Losses	$0
C/O Non-deductible expenses	$12,000

Basis in Debt

The first thing you will notice about the rules providing a shareholder basis in certain debts of the S corporation is that they are not nearly as expansive or forgiving as those found for partnerships in Section 752.

Under the partnership rules, a partner gets basis for his share of *all* of the partnership's debts, even those owed to third parties. To the contrary, a shareholder in an S corporation gets basis only for those debts made directly from the shareholder to the S corporation. Amounts owed by the S corporation to anyone but the shareholder do nothing to increase the shareholder's debt basis.

Despite this concise requirement, enterprising taxpayers have attempted any number of ways to claim debt basis for the purposes of utilizing losses, giving rise to a lengthy, and largely pro-IRS – body of case law. Some of the most common arguments include:

- The shareholder's guarantee of the S corporation's debt gives the shareholder basis. Verdict: it does not. Only when the shareholder is called upon to pay the guarantee, and does in fact pay the guarantee, will the shareholder receive debt basis.
- Loans from one corporation owned by the shareholder to a loss S corporation will give the shareholder debt basis in the loss corporation, since, you know…he *owns* both of the corporations. Verdict: it does not. The law is clear that the loan must be made directly from the shareholder to the S corporation; having the loan made by another entity – even a wholly-owned entity – will not get the job done. For an example of how to "fix" this type of structure, see here.

I would urge you to keep things simple. If you have a shareholder that needs debt basis in order to use anticipated losses, have him borrow the amount from the bank, loan it to the corporation, have the corporation give the shareholder a security interest in the assets of the S corporation, and then have the shareholder give the bank a security interest in the S corporation stock. That will generate the necessary debt basis increase.

Utilizing Debt Basis

Two important reminders about debt basis:

1. Debt basis is only relevant in utilizing losses.
2. Debt basis is only utilized to absorb losses after stock basis has been reduced to zero.

Example:

A owns 100% of S corp. On 1/1/2014, A had a stock basis of $25,000 and debt basis of $50,000. During 2014, S corp allocated to A non-separately stated loss of $41,000, long-term capital gain of $5,000, and Section 1231 loss of $6,000.

Stock and debt basis are utilized as follows:

Restoring Reduced-Basis Debt

While it sure is nice to be able to utilize losses against debt basis, there are lurking tax consequences to which tax advisors must be aware. While we don't tend to think of the repayment of debt as a taxable event – and clients will certainly never think of the repayment of debt as a taxable event – the fact remains that under Section 1271, the settlement of a debt is treated as an exchange of the debt. As a result, the holder of the debt generally recognizes gain or loss for the difference between the amount repaid and the holder's basis in the debt. Of course, the holder's basis is usually identical to the face amount of the debt, which is precisely why there is rarely a taxable event upon repayment.

In the S corporation arena, however, when a shareholder uses losses to reduce debt basis, his basis in the debt will drop below the face amount. As a result, if the debt is repaid prior to the basis in the debt being restored to the face value, the shareholder will recognize gain – generally taxable – for the excess. *Example:*

Continuing along the previous example, if the S corporation repays the $50,000 debt before the basis is restored, A will recognize $17,000 of capital gain upon the repayment – the excess of the $50,000 repayment over A's $33,000 basis in the debt.

Because of these rules, it is vital that a tax advisor warn a client that repayment of reduced basis debt will yield capital gain. Instead, if possible the client should refrain from repaying the debt until basis has been restored.

Restoring Debt Basis

The regulations provide that debt basis is restored pursuant to one of those lovely "if…then" determinations that are so often found in the Code. .

At year-end, the shareholder must determine whether he has been allocated a "net increase" or "net decrease" for the year. A net increase is defined as the excess of increases to basis (other than capital contributions) over decreases to basis. A net decrease, quite obviously, is just the opposite.

If the shareholder has been allocated a net increase, the shareholder increases and reduced-basis debt before any adjustments are made to stock basis. If a debt is repaid during the year, this increase is deemed to occur immediately before the repayment, potentially sparing the shareholder from a capital gain upon repayment.

Example:

A owns 100% of S Co. A has $0 stock basis on 1/1/2014. In 2012, A loaned $50,000 to S Co., but A has used $17,000 of losses against the debt basis and reduced the basis to $33,000. In 2014, S Co. allocates to A:

- *Nonseperately stated income: $41,500*
- *LTCG: $4,500*
- *Section 1231 loss: ($6,000)*
- *Distribution: ($18,000)*

A has a "net increase" of $22,000. Thus, A first increases the basis of the note by $17,000 from $33,000 to $50,000. The remaining $5,000 of net increase increases A's stock basis from $0 to $5,000. In table form, it looks like so:

This restoration of A's debt basis from $33,000 to $50,000 occurs even if the debt were repaid on January 2nd of 2014. The regulations provide that the basis increase occurs immediately prior to any repayment occurring within the year.

Conversely, if the shareholder is allocated a "net decrease" during the year, the shareholder must first adjust stock basis under the normal rules. Any losses in excess of stock basis may still be used to reduce the already-reduced debt basis.

Example: Same as the previous example, except A receives a distribution of $48,000.

A has a "net decrease "of $8,000. ($41,400 + $4,500 – $6,000 – $48,000) Thus, A does not increase his basis in the loan. Instead, A increases his stock basis from $0 to $46,000 to account for the income. Next, *A reduces the stock basis to $0 for the distribution, and $2,000 of distribution exceeds basis and generates capital gain under Section 1368.*

Finally, A's $6,000 of Section 1231 loss cannot be used against A's stock basis, because it has been reduced to $0. A can use the losses against his debt basis of $33,000 and further reduce his debt basis to $27,000

In table form:

	Stock	Debt
Beginning Basis	$0	$33,000
Net decrease of $8,000; so debt basis is not adjusted first.		
Increase stock basis by income	$46,000	
Reduce stock basis by distribution ($2,000 distribution in excess of stock basis generates capital gain. This distribution cannot be used against debt basis).	($46,000)	
Reduce debt basis by $6,000 loss; thus, there is no suspended loss		($6,000)
Ending basis	$0	$27,000

Note: if the $33,000 debt had been repaid during the year, A would not be permitted to reduce the debt basis by $6,000. The $6,000 loss would be suspended, and A would recognize $17,000 of capital gain on the repayment of the $50,000 debt.

Partial Repayment of Debt

The basis restoration and repayment rules contain a major trap for the unwary. If an S corporation repays reduced basis debt – even if the amount of the repayment is less than the shareholder's remaining basis in the debt – the repayment will generate capital gain to the shareholder if the shareholder's basis is not completely restored.

Example:

A loaned S Co. $100,000 in 2012. Losses have reduced the basis to $45,000 on 1/1/2014. On 7/1/2014, S Co. repays $30,000 of the loan. S Co. passes through $10,000 of income and a $15,000 distribution during 2014.

Because there is no "net increase," the basis of the repaid debt is not increased during the year. A increases stock basis from $0 to $10,000 for the income, reduces it by $10,000 for the distribution, and $5,000 of the distribution triggers capital gain.

On the partial repayment of the debt, gain is computed as follows:

*($100,000 (face amount) – $45,000 (basis))/$100,000 (face amount) * $30,000=$16,500*

Effectively, this rule provides that even though a shareholder is being repaid less than his basis in the debt, because the shareholder – in this example – has used 55% of the face value of the debt to absorb losses, 55% of any partial repayment of the reduced basis debt should generate capital gain. Thus, even *though the repayment is less than A's basis in the loan, he must recognize $16,500 of gain on the repayment. The other $13,500 of the repayment reduces A's basis in the note from $45,000 to $31,500.*

If S Co. had also allocated to A a loss during the year, A would be permitted to use the loss against his remaining debt basis of $31,500.

Multiple Loans

If a shareholder makes multiple loans to an S corporation, the regulations provide that debt basis is not reduced on a first-come/first-serve basis; rather, each debt is reduced in proportion that debt's basis as a percentage of total debt basis.

Then, when debt basis is being restored by a net increase, priority is given to any debt that was repaid during the year the net increase is generated. Any remaining net increase is allocated among the remaining debts based on the pro-rata basis of each debt as a percentage of total debts.

Character of Suspended Losses

When a shareholder's allocable share of the S corporation's losses exceeds the shareholder's basis of both his stock and debt, Reg. Section 1.1366-2 suspends the remaining loss. Any suspended loss is treated as a newly incurred loss in the immediately succeeding year, and thus falls into the standard basis ordering rules like any other loss.

Often overlooked by tax advisors, however, is the character of the loss: both the amounts that may be used currently and those suspended into the next year.

Consider the following example:

Bob owns 100% of S corporation. Bob's 2013 K-1 reflects the following:

- Ordinary loss: $6,000
- Capital loss: $3,000
- Section 1231 loss: $9,000
- Charitable contributions:$12,000

If Bob has a beginning basis of $10,000 before deducting the losses, how much and what is the character of loss deductible by him?

As a tax advisor, it would be tempting to pick and choose the most advantageous losses to utilize in the current year, while allowing the less advantageous losses to carry forward. For example, could Bob use currently the $6,000 ordinary loss and $4,000 of the Section 1231 loss, and simply let the remaining losses carry forward?

The regulations provide that no, Bob may not. Instead, in the year the losses are recognized, he must deduct a pro-rata portion of each loss. As a result, of the $30,000 of total losses, one-third of each loss ($10,000 basis/$30,000 losses) must be utilized currently. Thus, Bob must deduct $2,000 of ordinary loss, $1,000 of capital loss, $3,000 of Section 1231 loss and $4,000 of charitable contributions.

Of equal importance is the character of the losses that are suspended and carried forward. I have seen more than a few tax advisors, when preparing a fourth-quarter estimated tax payment calculation for a client, simply incorporate a lump-sum "ordinary suspended loss" into the software. The problem, of course, is that the suspended loss does not default to ordinary; rather, it maintains the character it had when it was generated.

Applying this principle to our example, Bob carries forward $20,000 of loss in excess of basis, and those losses maintain their character. Thus, Bob carries forward two-thirds of each type of loss — $4,000 of ordinary loss, $2,000 of capital loss, $6,000 of Section 1231 loss and $8,000 of charitable contributions. It looks like so:

Beginning Basis	$10,000	Suspended Losses
Ordinary Loss ($6,000/$30,000)*$10,000	($2,000)	$4,000
Capital Loss ($3,000/$30,000) * $10,000	($1,000)	$2,000
Section 1231 Loss ($9,000/$30,000)*$10,000	($3,000)	$6,000
Charitable Contribution ($12,000/$30,000) * $10,000	($4,000)	$8,000
Ending Basis	$0	$20,000

As you might imagine, ignoring the specific character of carryforward losses can lead to some embarrassing mistake come estimated payment time.

Transferability of Suspended Losses

The regulations provide that any losses in excess of a shareholder's basis in the stock and debt of the corporation are carried forward and treated as newly-incurred losses in the immediately succeeding tax year "with respect to that shareholder." Thus, suspended losses generally are not transferable from one shareholder to another.

Example:

A is a 20% shareholder in S Co. On January 1, 2014, A has $10,000 of basis in his S Co. stock. During 2014, S Co. allocates to A a $17,000 loss. On December 31, 2014, A sells his stock to B for $15,000.

The 2014 loss of $17,000 allocated to A reduces A's basis from $10,000 to $0, and $7,000 is suspended. A recognizes gain of $15,000 on the sale. The $7,000 of suspended losses do not carry over to B. Rather, they expire unused.

This example illustrates another common mistake made by tax advisors. The $15,000 of gain recognized on the sale of the stock neither "frees up" the suspended basis losses – as would be the case if the losses had been suspended due to the passive activity limitations of Section 469 – nor does it create basis allowing the shareholder to use the losses.

If a shareholder sells or transfers only a portion of his shares, however, he retains the full amount of any suspended losses.

Example:

A owns 50 shares of S Co. stock with a $0 basis and $10,000 of suspended losses. In 2014, A sells 20 of the shares to B for $5,000.

Because A sold only a portion of his shares, he retains ownership of the full $10,000 of suspended losses and may use them in the future if he generates stock basis.

Once again, the $5,000 gain from the sale of 20 shares of stock does NOT increase A's stock basis.

The only exception to the rule prohibiting the transfer of suspended losses is when a spouse transfers stock to another spouse, either while married or incident to a divorce. In that case, the suspended losses transfer over to the recipient spouse. After the Supreme Court's 2013 DOMA decision, this rule can now be utilized by same-sex couples, provided the couple is respected as married under state law.

Example:

A holds a $0 basis in his stock and has $8,000 of suspended losses. On 1/1/2014, A transfers all of her shares to her ex-husband, B. In this situation, B succeeds to A's $8,000 of suspended losses.

Lastly, if an S corporation has its election terminate, either by design or as the result of lost eligibility, the general rule would be that any suspended losses specific to a shareholder as of the termination date must expire unused. The regulations provide some relief, however, by allowing a shareholder to use the suspended losses if the shareholder increases his stock basis – and only stock basis – during the "post-termination transition period." This is generally the later of:

- One year after the election terminates, or
- The due date of the final S corporation tax return, including extensions.

Thus, a shareholder who contributes additional cash to the now-C corporation during this period can deduct any suspended losses as of the termination date.

Use of Stock Basis in Determining the Taxability of Distributions

Distributions of S corporation income should not be taxed a second time. Section 1368 achieves this result by providing that in the case of a distribution by an S corporation which has no accumulated E&P, the distribution is taxed under a two-tier approach:

1. First, the distribution is a tax-free reduction of the shareholder's basis in the corporation's stock; then

2. Any distribution in excess of the shareholder's stock basis is treated as gain from the sale or exchange of the underlying stock.

Because S corporation income first increases a shareholder's basis, from a mechanical perspective, the subsequent reduction in basis for the distribution of the income will not create a taxable event.

Example:

A owns 100% of the stock of S Co., an S corporation. On January 1, 2013, A has a basis in his S Co. stock of $30,000, and S Co. has an AAA balance of $10,000. S Co. has been an S corporation since formation and has no accumulated E&P. During 2013, S Co. allocates to A $50,000 of ordinary income and $30,000 of long-term capital loss and makes a distribution of $40,000 to A.

Because S Co. does not have any accumulated E&P, the distribution is first treated as a tax-free reduction of A's basis in his S Co. stock, with any excess distribution generating capital gain.

In order to determine the taxability of the distribution, A must adjust his stock basis. Pursuant to the *regulations, A first increases his beginning basis of $30,000 for the $50,000 of income allocated to A during 2013. A's adjusted basis of $80,000 is then reduced by the distribution of $40,000 before reduction for any losses or nondeductible expenses.*

The $40,000 distribution reduces A's basis in his S Co. stock from $80,000 to $40,000, and the entire distribution is tax-free pursuant to Section 1368(b).

Lastly, A reduces his remaining stock basis of $40,000 by the $30,000 of long-term capital losses allocated to him during 2013, leaving A an ending stock basis of $10,000.

If the distribution exceeds the shareholder's basis in the corporation's stock, the excess generates capital gain.

Example: Assume the same facts as the previous example, except S Co. generates only $20,000 of income and the distribution is increased to $60,000. A determines the taxability of the $60,000 distribution as follows:

Stock Basis

Beginning basis	$30,000
Increase for income	$20,000
Basis before distribution	$50,000
Reduce for distribution	($50,000)
Basis before losses	$0
Losses	($0)
Ending basis	$0

Because the $60,000 distribution to A exceeds A's basis in his S corporation stock of $50,000, only $50,000 of the distribution is a tax-free return of basis. The $10,000 of distribution in excess of A's basis in the S Co. stock is treated as amounts realized on the sale of the stock, resulting in capital gain. It is completely irrelevant whether A has basis in the debt of the S corporation, because the excess distribution may not be applied to reduce debt basis.

For a detailed look at the taxability of distributions, see this prior Tax Geek Tuesday.

Summary

In relative terms, subchapter S is a joy to deal with. Hopefully this foray through Sections 1366 and 1367 validate my contention that determining a shareholder's basis in S corporation stock and debt should not be an intimidating undertaking.

Got an idea for a Tax Geek Tuesday topic? Send it along to anitti@withum.com or on twitter @nittigrittytax.