Form 7203 and Reconstructing Basis

This week Kristen Parillo published an article in *Tax Notes Today Federal* looking at how the requirement to prepare and attach Form 7203 impacted this tax season that this author was quoted in.[1]

One of the key issues raised in the article was how to deal with new clients who lack basis information on their S corporation investments, either because they had been preparing their own return and had ignored basis rules (perhaps because they had no idea there were such rules) or their prior preparer had ignored the issue.

This article looks at the options that might exist to deal with these situations.

Why the IRS Created Form 7203

The IRS had been requiring S basis computations to be attached to tax returns for many years. The 1997 Schedule E instructions, the oldest version found on the IRS website, had this instruction that was to be used in preparing 1997 returns:

> If you are claiming a deduction for your share of an aggregate loss, attach to your return a computation of the adjusted basis of your corporate stock and of any debt the corporation owes you.[2]

The IRS made the requirement more explicit in 2018, adding a specific box that must be checked indicating if a basis calculation was required to be attached. Presumably the IRS added this because the agency noticed that such basis calculations were often not being attached.

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, excess farm loss, 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			☐		☐	☐
B			☐		☐	☐
C			☐		☐	☐
D			☐		☐	☐

[1] Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," *Tax Notes Today Federal,* June 1, 2022, https://www.taxnotes.com/tax-notes-today-federal/basis/new-basis-reporting-form-spotlights-role-proper-documentation/2022/06/01/7djjp (retrieved June 4, 2022)

[2] 1997 Instructions for Schedule E, Supplemental Income and Loss, p. 5, https://www.irs.gov/pub/irs-prior/i1040se--1997.pdf (retrieved June 4, 2022)

Now it appears the IRS has decided that even the check box had not gotten the attention of those filing returns, so the agency created Form 7203 that must be attached to Form 1040 if the taxpayer:

- Is claiming a deduction for their share of an aggregate loss from an S corporation (including an aggregate loss not allowed last year because of basis limitations),
- Received a non-dividend distribution from an S corporation,
- Disposed of stock in an S corporation (whether or not gain is recognized), or
- Received a loan repayment from an S corporation.[3]

[3] Instructions for Form 7203 (12/2021), January 19, 2022, https://www.irs.gov/instructions/i7203#en_US_202112_publink100045402 (retrieved June 4, 2022)

The first page of Form 7203 is reproduced below:

Form **7203** (December 2021) 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(s) shown on return | **Identifying number**

Name of S corporation | **Employer identification number**

Stock block (see instructions) ►

Part I Shareholder Stock Basis

1	Stock basis at the beginning of the corporation's tax year			1	
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			
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	
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	
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	

Part II Shareholder Debt Basis

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

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

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 56396V Form **7203** (12-2021)

The page contains the full computation of stock basis in Part I and the beginning of the shareholder's basis in debt in Section A of Part II.

The second page of Form 7203 contains the following:

Form 7203 (12-2021) Page **2**

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

Section B—Adjustments to Debt Basis

	Description	**Debt 1**	**Debt 2**	**Debt 3**	**Total**
21	Debt basis at the beginning of the corporation's tax year				
22	Enter the amount, if any, from line 17				
23	Debt basis restoration (see instructions)				
24	Debt basis before repayment. Combine lines 21, 22, and 23				
25	Divide line 24 by line 18				
26	Nontaxable debt repayment. Multiply line 25 by line 19				
27	Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24				
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-				
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-				

Section C—Gain on Loan Repayment

		Debt 1	**Debt 2**	**Debt 3**	**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.** Combine 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** (12-2021)

Big Deal or Not So Much?

The *Tax Notes Today Federal* article looked at the impact of this form on the past tax season. As the article notes:

> Whether preparing Form 7203 for the first time was a straightforward task or a nightmare for tax professionals seems to depend on the basis tracking history and recordkeeping skills of whoever handled the shareholder's previous tax returns.[4]

The article quotes a number of tax professionals who have found issues with both returns previously prepared by taxpayers and even those prepared by other tax professionals when taking on a new client.

[4] Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," *Tax Notes Today Federal,* June 1, 2022

Taxpayers are ultimately responsible for tracking the basis in their investments. For partnerships and S corporations this requires tracking much more than simply how much the taxpayer paid for his/her interest.

For stock in an S corporation that basis is tracked under rules found at IRC §1367 after the initial basis of the interest is determined at acquisition. This basis number is used for the following purposes:

- Limiting the amount of net losses that may be deducted by the shareholder on their Form 1040
- Determining if any non-dividend distributions received from the S corporation are considered a return of capital or taxable as a capital gain and
- Computing gain or loss on the sale or exchange of the S corporation shares.

S corporation shareholders also have to track basis in any amounts they have loaned to the S corporation. Such debt basis is important as

- A source of basis for deducting losses from the S corporation should stock basis be exhausted or
- Determining the proportion of any principal repayment that is considered taxable gain vs. a return of the debt basis in the loan.

Debt basis cannot be used to convert taxable distributions in excess of stock basis to a nontaxable status. As well, if debt basis is not restored by year end (before taking into account current year losses), *any* repayment of the debt will lead to taxable income based on the ratio of the basis remaining in the debt to the outstanding principal of the debt.

Thus, basis in stock and debt must be referred to in preparing a shareholder's Form 1040 in the following cases:

- The K-1 shows a net loss being passed out to the shareholder for the tax year;
- Prior year losses suspended due to a lack of basis flow into the current year return;
- Distributions (other than tax dividends) are paid to the shareholder during the tax year;
- Any debt from the shareholder to the S corporation is fully or partially repaid during the year; or
- The S corporation interest is sold or exchanged during the year.

Not coincidentally, this list corresponds to the situations where the IRS demands that Form 7203 be attached to the tax return in order to document any of the following positions on the return:

- The losses claimed on the individual return are allowed to be claimed in the year in question;
- Some or all distributions are not taxable to the shareholder as a gain;
- Any amount of the repayment of shareholder loans is not taxable to the shareholder; and
- The gain or loss on disposition of the S corporation shares has been properly computed, which includes the disposition of the shares in a year the S corporation is liquidated.

When the New Client Hasn't Tracked Basis

If the taxpayer begins tracking basis with the first return the S corporation investment appears on, Form 7203 presents no real challenge in most cases. The *Tax Notes Today Federal* article quoted Nathan Smith of CBIZ Inc. on how difficult the Form 7203 processing was:

> "We saw a few questions come up from time to time, but by and large it was pretty much smooth sailing," said Nathan Smith of CBIZ Inc. "Unlike the Schedule K-2 and K-3 disaster, the new standardized reporting on Form 7203 was fairly seamless."[5]

But the article notes that things become a lot more difficult if the professional takes on a new client who has not been tracking the information:

> While the form wasn't a struggle for those who were already tracking basis, it highlighted the problem that tax professionals face when taking on new clients who weren't tracking it themselves and whose preparers weren't doing it either.[6]

A client who comes to the practitioner with no prior records related to basis has always required the practitioner to deal with obtaining information to determine what is beginning basis and if the taxpayer may have reported losses in the past or avoided reporting gain on distributions that means prior returns contain errors.

There are various ways a professional may obtain basis information. For now, we'll consider three options that the practitioner should consider.

Recalculate Basis from Day One

Clearly the best option to deal with obtaining basis information for a taxpayer who has not tracked basis in the past is to obtain the information for each prior year to properly compute stock and debt basis. The Form 7203 itself serves as an excellent set of worksheets to prepare for each year to obtain a comprehensive and easily defendable calculation of basis up through the beginning of the year the practitioner is first looking to prepare.

One key fact to keep in mind is the absolute rule that basis can *never* go below zero. Generally, if events occur that would push basis below zero, the "excess" reduction is taken care of either by limiting deductions to the amount that takes basis to zero (and carrying such disallowed losses to the next taxable year) or by recognizing a gain on distributions.

Later we'll discuss options to deal with this situation in closed years based on IRS documents. While these documents are not binding authority, they contain analyses that do cite to binding authority and aren't likely to be challenged by IRS examiners if the taxpayer conforms to the methods described.

But, for now, when computing basis we simply note that such "problematical" events occurred in a year but still treat ending basis as zero.

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[5] Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," *Tax Notes Today Federal,* June 1, 2022

[6] Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," *Tax Notes Today Federal,* June 1, 2022

While this option is by far the best, in many cases it is not possible to obtain all data necessary to do the full calculation using the schedules for each year. We'll discuss some options to deal with this situation, realizing that it's very possible the IRS will challenge any such calculation on exam—and may very well succeed in pushing down the basis.

Even if it is possible to obtain the data, clients may balk at the effort and cost involved in obtaining the data. The adviser should strongly suggest the client take the steps necessary to obtain the information and have fully supported basis calculations should the IRS examine his/her return. Remember that the problem exists because the taxpayer failed to take the steps *required* of the taxpayer to prepare the prior year's returns.

While that may have been due to inadequate work done by a paid preparer, it's not due to inadequate work done by the preparer taking on the return—but if the preparer simply acquiesces in the client's whining about not wanting to have the work done to properly calculate basis, the preparer may find that he/she now will be deemed by the client to have "blessed" the less desirable method—and the client may look for compensation should the IRS successfully challenge the return later.

IRS LB&I Process Unit Methods

The *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*[7] describes a number of issues IRS examiners may encounter in examining S corporations and their shareholders. The recommendations for steps for examining agents to take when faced with imperfect information on basis are found in this document.

In the section entitled "Losses Claimed in Excess of Basis" the document suggests the following steps be taken when historical information is not available:

> When historical records are not available to substantiate the shareholder's initial stock basis or the adjustments to basis since making the S election, estimate initial stock basis by taking the earliest S corporation return available and adding:
>
> - beginning capital stock,
> - beginning additional paid-in capital,
> - beginning accumulated adjustments account, and
> - beginning other adjustments account.
>
> Multiply the total by the shareholder's ownership percentage to arrive at each individual's estimated initial stock basis[8]

[7] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018, https://www.irs.gov/pub/irs-utl/sco_p_53_05_01_03_06.pdf (retrieved June 5, 2022)

[8] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

The document provides two examples of performing such a calculation:

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

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

*Accumulated Adjustments Account (AAA)

**Other Adjustments Account (OAA)

	Beginning	Ending
Capital Stock (Line 22)	45,000	60,000
Additional Paid in Capital (Line 23)	0	0
Retained Earnings (Line 24)	(22,000)	(86,000)

	AAA*	OAA**
1. Balance at beginning of the Year	(21,000)	1,000
2. Ordinary Income from page 1, line 21	0	
3. Other additions	0	0
4. Loss from page 1, line 21	(64,000)	
5. Other reductions	0	0
6. Combined lines 1 through 5	(85,000)	1,000
7. Distributions other than dividends	0	0
8. Balance at end of year	(85,000)	1,000

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

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

If there is more than one shareholder, multiply the $25,000 by each shareholder's ownership percentage to determine each shareholder's estimated initial stock basis. For example, if there are two equal shareholders, then take the estimated beginning stock basis of $25,000 times 50-percent ownership, which equals $12,500 of estimated beginning stock basis for each shareholder.[9]

[9] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

Example 2 – Estimating Initial Stock Basis Using the Return Results in Negative Basis[10]

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

	Beginning
Capital Stock (Line 22)	45,000
Additional Paid in Capital (Line 23)	0
Retained Earnings (Line 24)	(22,000)

	AAA	OAA
1. Balance at beginning of the Year	(98,000)	0
2. Ordinary Income from page 1, line 21	0	
3. Other additions	0	
4. Loss from page 1, line 21	(64,000)	
5. Other reductions	0	
6. Combined lines 1 through 5	(162,000)	0
7. Distributions other than dividends	0	
8. Balance at end of year	(162,000)	0

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

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

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

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

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

[10] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

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

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

Name of Corporation
Shareholder's Name – Stock Basis Computation Worksheet
2012

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

Computation of Shareholder Basis

Shareholder Name	0	Initials	0
Taxpayer ID Number	0	Date	1/0/1900
Income Year	Prior Years		

Schedule 1

	Total Distributive Shares			Basis and Suspended Losses					Debt
	1 Prior Year Suspended Losses	2 Current Distributive Shares	3 Total [1+2]	4 Stock Basis	5 Debt Basis Schedule 1a	6 Current Losses Allowed [4+5]	7 Losses Claimed that Can't be Adjusted	8 Current Suspended Losses [3-6-7]	9 Face Amount of Debt Schedule 1a
A. Beginning Balance				0	0				0
B. Additions				0	0				0
C. Subtotal [A+B]				0	0				0
D. Additions:									
-Ordinary Business Income		0	0						
-Net Rental Real Estate Income		0	0						
-Other Net Rental Income		0	0						
- Interest Income		0	0						
-Ordinary Dividends & Royalties		0	0						
-Net ST & LT Gain		0	0						
-Net Section 1231 Gain		0	0						
-Other Income		0	0						
-Tax Exempt Income		0	0						
-Excess Depletion Adjustment		0	0						
-Recapture of Business Credits		0	0						
E. Total Additions			0	0	0				
F. Subtotal [C+E]				0	0				
G. Suspense Account	63,000			0	0		63,000		
H. Decrease Basis for Income not reported in closed year					0				

Instructions | Input_Sheet | Tab 1 | Tab 2 | Tab 3 | Tab 4 | Tab 5 | Tab 6 | Tab 7 | Tab 8 | Tab 9 | Tab 10 | 1a

The document also notes that it's important to understand how the S corporation shareholder acquired his/her shares when using these estimation methods:

Note: It is important to establish how and when each shareholder acquired basis in the S corporation as the above estimate may need to be modified as a result of ownership changes. If the estimate appears to be unreasonable based on the facts and circumstances, then consider using zero as the initial stock basis.[11]

Other Methods – Cohan Case

The basic authority for the estimation methods the IRS discussed comes from the case of *Cohan v. Commissioner*.[12] That case established that if the evidence makes it clear that the taxpayer should qualify for some deduction but does not have sufficient records to document the amount, the taxpayer will still be allowed some deduction to the extent the amount he/she should be allowed can reasonably be estimated, taking into account the taxpayer's level of responsibility for a lack of adequate records.

While the IRS clearly is relying on this case to justify the proposed methods, an adviser might find some other reasonable methodology to compute basis and then be ready to defend that method if necessary.

Losses Previously Claimed in Excess of Basis

The IRS document goes on to advise examining agents regarding what to do when they discover losses in excess of basis have been claimed in prior years. Advisers may discover the same issue when looking to determine basis for new clients.

Step 2 of the process of dealing with losses claimed in excess of basis discussed first the absolute rule, noted earlier, that basis can never drop below zero, so basis becomes zero for the year following the year when excess losses are claimed:

> Stock basis can never be reduced below zero. Therefore, even if a loss is claimed in excess of basis, the stock basis at the beginning of the following year is zero.[13]

If these losses were claimed in years closed to IRS assessments by statute, you might think this reset to zero means the taxpayer "wins" in this case, but the document goes on to provide a methodology that could very well allow the IRS to recover that excess tax benefit by using a suspense account:

> National Office's position is that if a shareholder claims losses in excess of basis in a year closed by statute, then the shareholder must suspend all future tax-free distributions and losses from the S corporation until the excess losses claimed, but not allowed, are recaptured. FSA 200230030; TAM 200619021 and PLR 9304004.[14]

As is noted, the IRS has brought this concept up in documents dating back to 1993.

[11] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[12] *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930)

[13] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[14] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

The guide also provides the agent with citations to use against an attempt by the taxpayer to argue the agent has no right to look at "closed" years:

> IRC 7602(a)(1) authorizes the examiner to examine any books, papers, records, or other data which may be relevant or material to determine the correctness of any return, including information from prior years not under examination or closed by statute. IRC 6214(b) allows the Tax Court to determine the correct tax liability for the open year(s) by referring, as necessary, to facts from other years. *Lone Manor Farms, Inc. v. Commissioner* - 61 T.C. 436, 440-441 (1974); *Goldsmith v. Commissioner* - T.C. Memo. 2017-20.[15]

The document outlines how the suspense account is absorbed in open years:

> If a taxpayer claims a loss in excess of basis in a closed statue year, then a suspense account is created, pursuant to IRC 1366(d)(2), to track the excess losses. The balance in the suspense account must be reduced to zero before the taxpayer is allowed to take tax-free non-dividend distributions or report pass-through losses. TAM 200619021 explains that the "suspended basis losses claimed in error" should reduce stock basis before current year distributions, non-deductibles and losses and deductions are taken into account.[16]

The steps the LB&I document outlines for agents to take are:

- Review the basis computation schedule and identify any years for which the losses and deductions exceed the shareholder's basis.
- Compare the basis computation to the shareholder's return to determine if the losses claimed in closed statute years exceed basis.
- Establish or increase the suspense account for any losses and deductions claimed in excess of basis in closed statute years.[17]

The document provides the following example of applying these procedures:

<u>Example 3 – Suspense Account</u>[18]

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

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

[15] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[16] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

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

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

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

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

S Corporation
Mary – Stock Basis Computation Worksheet
2013

STOCK BASIS

1	**Stock Basis at Beginning of Year** (cannot be negative)							$ -
2	**Increase for Capital Contribution or Additional Stock Purchase**							
	Capital Contribution						$ -	
	Stock Purchase						-	-
3	**Increase for Income & Gain Items**	***2012 Sch. K-1***						
	Ordinary Business Income	*Line 1*			$ 5,000			
	Separately Stated Income:							
	Net Rental Real Estate Income	*Line 2*			-			
	Other Net Rental Income	*Line 3*						
	Decrease for Depletion	*Line 17 (R)*			-	-	-	
	Decrease for Business Credits (see IRC §50(c)(1) & (5))				-	-	-	-
	Note: If the above exceed stock basis, the excess is applied to the S/H's debt basis. The amount in excess of debt basis is not carried over.							
10	**Stock Basis Before Allowable Losses & Deductions** (cannot be negative)							5,000
11	**Decrease for Loss & Deduction Items**	***2012 Sch. K-1***	Current Year Distributive Share	Carryover Amount #	Allowable Loss & Deductions	Losses Claimed That Can't be Adjusted @	Suspended Basis C/O	
	Ordinary Business Loss	*Line 1*	-	-	-	-	-	
	Separately Stated Loss & Deductions:							
	Net Rental Real Estate Loss	*Line 2*		-	-	-	-	
	Other Net Rental Loss	*Line 3*	-	-	-	-	-	
	Net ST & LT Capital Loss	*Lines 7 & 8a*	-	-	-		-	
	Net Section 1231 Loss	*Line 9*	(8,000)	-	(4,444)	(3,556)	0	
	Other Loss	*Line 10 (A-E)*	-	-	-	-	-	
	Section 179 Deduction	*Line 11*	-	-	-	-	-	
	Charitable Contributions	*Line 12 (A-G)*	(1,000)	-	(556)	(444)	(0)	
	Investment Interest Expense	*Line 12 (H)*	-	-	-	-	-	
	Deductions - Royalty Income	*Line 12 (I)*	-	-	-	-	-	
	Section 59(e)(2) Expenditures	*Line 12 (J)*	-	-	-	-	-	
	Portfolio Income Expenses	*Line 12 (K-L)*	-	-	-	-	-	
	Other Deductions	*Line 12 (M-O & S)*	-	-	-	-	-	
	Foreign Taxes Paid/Accrued	*Line 14 (L-M)*	-	-	-	-	-	
						(4,000)	(0)	
	Total Allocated Loss & Deductions	(9,000)						
	Total Allowable Loss & Deductions							(5,000)
12	**Stock Basis at End of Year** (cannot be negative)							$ -

	Total Distributive Shares			Basis and Suspended Losses					Debt
	1 Prior Year Suspended Losses	2 Current Distributive Shares	3 Total [1+2]	4 Stock Basis	5 Debt Basis Schedule 2a	6 Current Losses Allowed [4+5]	7 Losses Claimed that Can't be Adjusted	8 Current Suspended Losses [3-6-7]	9 Face Amount of Debt Schedule 2a
A. Beginning Balance				0	0				0
B. Additions				0	0				0
C. Subtotal [A+B]				0	0				0
D. Additions:									
-Ordinary Business Income		5,000	5,000						
-Net Rental Real Estate Income		0	0						
-Other Net Rental Income	0	0					0		
-Net ST & LT Capital Loss	0	0	0	0	0		0	0	
-Net Section 1231 Loss	0	8,000	8,000	4,444	0	4,44	3,556	0	
-Other Loss	0	0	0	0	0		0	0	
-Section 179 Deduction	0	0	0	0	0		0	0	
-Charitable Contributions	0	1,000	1,000	556	0	55	444	0	
-Investment Interest Expense	0	0	0	0	0		0	0	
-Deductions - Royalty Income	0	0	0	0	0		0	0	
-Section 59(e)(2) Expenditures	0	0	0	0	0		0	0	
-Portfolio Income Expense	0	0	0	0	0		0	0	
-Other Deductions	0	0	0	0	0		0	0	
-Foreign Taxes Paid/Accrued	0	0	0	0	0		0	0	
O. Total Subtractions			9,000	5,000	0		4,000		
P. Subtotal [M-O]				0	0				
Q. Net Increase (Decrease) [E-J-L-O]			-4,000						
R. Other Stock Reductions and Debt Repayments				0	0				0
S. Ending Balance (Not Below Zero)				0	0				0

The IRS document discusses the general rules for handling losses in excess of basis

> The amount of losses and deductions taken by a shareholder for any taxable year cannot exceed the sum of the shareholder's stock basis and the adjusted basis of any S corporation indebtedness owed to the shareholder (debt basis).
>
> When stock and debt basis is insufficient, and there is more than one type of loss or deduction item that reduces basis, the amounts allowed as losses or deductions are allocated on a pro rata basis. The pro rata allocation is computed dividing the loss or deduction item by the total loss and deduction items and multiplying the resulting percentage by the available basis.
>
> Any losses or deductions disallowed for any taxable year are suspended and carried forward indefinitely until the shareholder has adequate stock or debt basis. The suspended losses retain their character and are carried forward and treated as incurred in the first succeeding year.

If the stock is sold or otherwise disposed of, then the suspended losses are no longer carried forward and are lost forever.[19]

The IRS outlines the following steps to absorb suspense accounts:

- If the shareholder has a suspense account, then reduce the shareholder's basis by the lesser of
  - the absolute value of the suspense account, or
  - the basis after the current-year increases.
- Review the basis computation schedule and identify open statute years for which the losses and deductions exceed the shareholder's basis.
- Compare the basis computation to the shareholder's return to determine if the losses claimed in open statute years exceed basis.
- Disallow any losses or deductions in excess of basis, verifying that each loss or deduction item is properly limited on a pro-rata basis.[20]

The IRS provides two examples of applying the rules:

Example 4 – Allocation of Losses and Deductions[21]

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

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

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

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

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The carry over to the next taxable year is:

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

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

Example 5 – Treatment of Suspended Loss Items[22]

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

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

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

Beginning Stock Basis Year 2	0
Ordinary Income	35,000
Stock Basis Before Non-Deductible Exp.	35,000
Non-Deductible Travel & Entertainment	(5,000)
Stock Basis Before Losses & Deductions	30,000

Ordinary Loss	(10,400)	(0 + (10,400))
IRC 1231 Loss	(10,000)	
Cash Charitable Contribution	(3,600)	((1,000) + (2,600))
Ending Stock Basis Year 2	6,000	

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

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