



# Fundamentals of S Corporation and Partner Basis

January 7, 2020

 Briggs & Veselka Co.  
CPAs and Business Advisors  
*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

2

## Objectives

- Importance of maintaining basis
- Identify the increases and decreases to shareholder basis, and review the ordering rules for items that affect shareholder basis
- Review partnership basis rules
- Examine taxable events or limitations that arise from limited shareholder or partner basis
- Differences between basis and at-risk limitations

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

## What is Basis?

3

IRS defines basis generally as the amount of one's investment in a property for tax purposes.

- Investment in the business
- Economic outlay

Important because basis:

- Ultimately determines gain or loss on disposition
- Limits the deductible losses the shareholder or partner can deduct.
- Limits the tax-free distributions

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

## Who is Responsible for Calculating Basis?

4

- Technically, it is the shareholder or partner's responsibility.
- General practice is the tax preparer is maintaining basis.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

## New for 2018

5

From the Schedule E page 2 instructions  
(Not New)

If you are claiming a deduction for your share of an aggregate loss, check the box on the appropriate line in Part II, column (e), and **attach to your return a computation of the adjusted basis of your corporate stock and of any debt the corporation owes you**. For details, see the Shareholder's Instructions for Schedule K-1 (Form 1120S).

*February 6, 2019 announcement from IRS on the Website for Sch E instructions.*

As stated in Part II of the Schedule E (Form 1040), a taxpayer who owns an interest in an S corporation and reports a loss, receives a distribution, disposes of stock, or receives a loan repayment from the S corporation must check a corresponding box under line 28, column (e), and attach a computation detailing their S corporation basis. The discussion about basis rules for S corporations in the Instructions for Schedule E (Form 1040) for Parts II and III does not limit or modify this requirement.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

## Shareholder Basis-S Corps

6

- Stock basis is what a shareholder invests in the stock of the corporation. Usually, stock basis comes in the form of the initial capital contribution. The shareholder may make additional capital contributions in the form of cash or property.
- Debt basis is the result of the shareholder making a direct loan to the corporation. There must exist a direct debtor-creditor relationship. The shareholder's personal guarantee of corporate debt does not create shareholder basis.
- Outside Basis-used to describe basis acquired outside of the S Corporation. e.g., inheritance, gift, purchased from existing shareholder

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

## Increases to Basis

7

- Additional capital contributions
- Direct loans made to the corporation by the shareholder
- Allocated share of the corporation's items of income, such as ordinary income, capital gain income, etc.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

## Decreases to Basis

8

- Distributions of cash and property
- Repayments of direct loans made to the corporation by the shareholder
- Allocated share of the corporation's items of deduction and loss, such as ordinary loss; capital losses, IRC §179 depreciation, etc.
- Nondeductible expenses
- Excess of the deduction for depletion over the basis of the property subject to depletion

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

9

## Debt Basis Information

- **Direct Shareholder Loans to Corporation**
  - No-The creation of a loan through a mere bookkeeping entry on the corporation's books, or the agreement by a shareholder to lend additional funds on demand by the corporation.
- **Direct Shareholder Loans w/Borrowed Funds**
  - This is acceptable as long as the shareholder has an actual liability to an outside bank.
- **Loans From Sale of Property to Corporation**
  - Look to basis in note-if sale was on installment sale, don't have full basis yet.
- **Purchase or Substitution of Debt-Special Rules**
  - Purchase has to be with cash, substitution only works if corporation is in no way a party to the debt.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

10

## Accumulated Adjustments Account

AAA is the accumulation of the corporation's total income, deductions, and distributions (of that income) while an S-Corporation.

Very important and required to keep track of if corporation was previously a C Corporation.

- Not the same as basis
- Basis is shareholder specific and encompasses more than AAA (for example outside basis)

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

11

## Ordering Rules

Stock basis is adjusted in the following order:

1. Increased for contributions of cash and property
2. Increased for income items
3. Decreased for distributions of cash and property
4. Decreased for non-deductible, non-capital expenses
5. Decreased for items of loss and deduction.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

12

## Ordering Rules

Debt basis is affected as follows:

1. Increased for new shareholder-to-corporation loans
2. Decreased for shareholder-to-corporation repayments.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

## Election

13

Election is available to decrease basis by items of loss and deduction before non-deductible expenses.

1.1367-1(g) election, irrevocable, can be made any time

### Example:

ELECTION TO ADJUST BASIS OF SHAREHOLDER STOCK IN S CORPORATION PURSUANT TO REG. SECTION 1.1367(g)  
*Jane Doe, a shareholder in ABC Corp, EIN 12-3456789 hereby elects, the basis ordering rules provided in Reg. Sec. 1.1367-1(g), and further agrees to treat any amount described in Reg. Sec. 1.1367-1(f)(3) that is in excess of the shareholder's basis in stock and indebtedness in ABC Corp as an amount described in Reg. Sec. 1.1367-1(f)(3) in the succeeding tax year.*

*A Legacy of Loyalty*




Briggs & Veselka Co.  
CPAs and Business Advisors

## Suspended Losses

14

- Losses and deductions in excess of both stock and debt basis are suspended
- Carried forward to the following year (indefinitely until final year)
- The character of the loss and deduction items is retained and the items are carried forward proportionately.

*A Legacy of Loyalty*




15


**Briggs & Veselka Co.**  
CPAs and Business Advisors

## Suspended Loss Example

---

2019 K-1 Income		
Box 1	Ordinary	2,326,669
Box 2	Net Rental	13,001
Box 4	Interest	49,303
Box 8a	LT Cap	(131)
Box 9	Net 1231	500,584
Box 12	Charitable	140,320
Box 16C	Nondeductible	442,820
Prior Year Loss Carryovers from 2018		
Schedule E		3,298,328
LT Capital		6,408
Section 1231		163,190
Contributions 50%		282,207
Nondeductible Exp		864,894






16

**Briggs & Veselka Co.**  
CPAs and Business Advisors

## Suspended Loss Example

---

Allocation of Income and Basis	INCOME	LOSS	PERCENT OF LOSS	ALLOCATION OF INCOME	DISALLOWED LOSSES
Ordinary	2,326,669				
Rental	13,001				
Schedule E C/O		3,298,328	0.847771954	2,449,685	848,643
LT Capital		131	0.000033671	97	34
LT Capital C/O		6,408	0.001647054	4,759	1,649
Form 4797	500,584				
Section 1231 C/O		163,190	0.041944860	121,202	41,988
Interest	49,303				
Charitable Contributions		140,320	0.036066565	104,216	36,104
Charitable C/O		282,207	0.072535897	209,597	72,610
	2,889,557	3,890,584	1.000000000	2,889,557	1,001,027
Nondeductible Exp C/O		864,894.00			
Nondeductible Exp CY		442,820.00			
		1,307,714.00			







Briggs & Veselka Co.  
CPAs and Business Advisors

17

## Taxable Events

- Distributions in excess of stock basis is taxable to the shareholder as capital gain income.
- Repayments of reduced basis shareholder debt (debt whose basis has been used to deduct losses and deductions) are taxed as ordinary income.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

18

## Restoration of Basis

- The shareholder makes a capital contribution to the corporation
- The shareholder makes additional loans
- The corporation generates net income
- In the case of the capital contribution, stock basis restored first. In the case of generated income, debt basis is restored first.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

19

## Restoration of Basis Example

Beginning of year: Stock Basis \$0, Principal on loans from shareholder \$50,000, remaining \$40,000 debt basis

CY Taxable Income of \$5,000, \$0 Contributions, no repayments

Stock Basis	\$0
CY Income	5,000
Less amount used to restore debt basis	<u>(5,000)</u>
End of Year Stock Basis	\$0

Beginning Debt Basis	\$40,000
Restored from Income	<u>5,000</u>
Ending Debt Basis	\$45,000

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

20

## Former C Corporation Distributions

- S Corporations with C Corporation earnings and profits (E&P) are subject to the distributions ordering rules.
- For S Corporations with no E&P, distributions are applied against basis of the shareholder's stock. If the distribution exceeds the adjusted basis of the stock, the excess is capital gain.
- For S Corporations with E&P, distributions not exceeding AAA are tax-free. The remainder is treated as a dividend to the extent it does not exceed E&P. Any remaining distribution not in excess of basis is tax-free. The remaining distributions are capital gain income.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

21

## S Corporation Liquidation

- In a complete corporate liquidation, pass-through losses suspended because of basis limitations are lost.
- The shareholder should consider creating additional basis before the final distribution through additional capital contributions or loans.
- Liquidating (as opposed to operating) distributions of C Corporation E&P are not taxed as dividends. (doesn't mean tax free)

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

22

## At-Risk Basis

- There are three limitations for the deductibility of losses and deductions (in this order).
  1. Basis Limitation
  2. At-Risk Limitation
  3. Passive Losses Limitation
- The shareholder must be on the hook (at-risk) for the economic outlay.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

23

## Partnership Basis

- A partner's basis in the partnership interest increases by an allocable share of all partnership income, including income exempt from taxation, and decreases by an allocable share of all partnership losses, including nondeductible, noncapital expenditures. This basis adjustment mechanism is a key component of insuring that partnership income is taxed only once. Accordingly, a partner applies partnership distributions to reduce the basis in the partnership interest.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

24

## Increases to Partnership Basis

- Increases to Partnership Basis
  - Additional contributions to the partnership
  - Increased share of, or assumption, of liabilities
  - Distributive share of taxable and nontaxable income
  - Partner's distributive share of the excess of deductions for depletion over the basis of the depletable property, unless the property is oil or gas wells whose basis has been allocated to partners.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

25

## Decreases to Partnership Basis

- Decreases to Partnership Basis
  - Cash and property distributed to the partner.
  - Decreased share or assumption of liabilities
  - Distributive share of the partnership losses.
  - Distributive share of the nondeductible expenses
  - Depletion for any partnership oil and gas wells up to the proportionate share of the adjusted basis of wells allocated to the partner.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

26

## Effect of Partnership Liabilities

Basis in a partnership includes the partner's share of a liabilities only if liability:

- Creates or increases the partnership's basis in any of its assets,
- Gives rise to a current deduction to the partnership OR
- Is a nondeductible, noncapital expense of the partnership.

*A partner's share of accrued but unpaid expenses or accounts payable of a cash basis partnership are not included in the adjusted basis of the partner's interest in the partnership.*

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

27

## Effect of Partnership Liabilities

Partner's basis increased-If a partner's share of partnership liabilities increases, or a partner's individual liabilities increase because he or she assumes partnership liabilities, this increase is treated as a contribution of money by the partner to the partnership.

Partner's basis decreased-If a partner's share of partnership liabilities decreased, or a partner's individual liabilities decrease because of the partnership assumes his or her individual liabilities, this decrease is treated as a distribution of money to the partner by the partnership.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

28

## Partnership At-Risk Basis

- Economic Risk of Financial Loss or what the partner stands to lose financially
- When a partner loans money to the partnership, or makes a capital contribution to the partnership, he or she is at risk of losing these funds.
- These provide at-risk basis. This is important to be able to deduct losses.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

29

## Types of Partnership Liabilities

### Recourse Debt

- Partner or related person bears the economic risk of loss
- Economic risk of loss=obligation if the partnership was constructively liquidated

### Non-Recourse Debt

- A partnership liability to the extent that no partner or related person bears the economic risk of loss for that liability.
- Generally true of LLC liabilities

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors


30

## Qualified Nonrecourse Debt

- Secured by real property
- Funds are borrowed from a "qualified person", or from or guaranteed by, any federal, state, or local governmental.
- Generally, no person is personally liable for repayment of the funds.
- The loan does not constitute convertible debt.

*A Legacy of Loyalty*

31



Briggs & Veselka Co.  
CPAs and Business Advisors


## Comparison Basis and At-Risk Basis

PARTNERSHIP	Basis	At-Risk
Contributions of cash and property	↑	↑
Assumption of nonrecourse debt	↑	
Assumption of recourse debt	↑	↑
Share of partnership Income items	↑	↑
Distributions of cash or property	↓	↓
Relief from nonrecourse debt	↓	
Relief from recourse debt	↓	↓
Share of partnership Loss items	↓	↓

Note: Qualified nonrecourse treated as recourse

A Legacy of Loyalty

32



Briggs & Veselka Co.  
CPAs and Business Advisors

## Partner Contribution of Property

- §721 Nonrecognition of gain or loss on contribution
- Partner normally doesn't recognize gain or loss when he makes contribution of property.
- Basis of property becomes basis in the partnership interest.
  - Exceptions:
    - Contributions to an investment partnership (over 80% of the value of its assets are held for investment and are stocks and securities)
    - Contribution of liabilities

A Legacy of Loyalty





Briggs & Veselka Co.  
CPAs and Business Advisors

33

## Liabilities Assumed by Partnership

- Property contributed to partnership subject to a debt
- Partner's liabilities are assumed by the partnership
- Basis is reduced (but not below zero) by the liability assumed by other partners.
- Example: Bob contributes land with basis of \$20,000 and mortgage of \$5,000 in exchange for 30% interest in partnership. His basis in partnership interest is: ??

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

34

## Liabilities Assumed by Partnership

- §752 Treatment of certain liabilities
- If assumed liability exceeds basis of property contributed then partner would recognize capital gain.
- Example: Bob contributes land with basis of \$20,000 and mortgage of \$50,000 in exchange for 30% interest in partnership. His basis in partnership interest is: ??
- Relief of liabilities can often cause surprise tax bills.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

35

## Partnership Distributions

### §731 Extent of recognition of gain or loss on distribution

In general, no gain recognized unless cash distributed exceeds adjusted basis of partner's interest

No loss recognized except upon a liquidating distribution where the ONLY property received is money, unrealized receivables, or inventory and it does not exceed partner basis.

### Property distributions:

- Character of the distributed property in the hands of partner is same as in partnership. i.e. unrecaptured depreciation will trigger ordinary income when sold by the partner eventually
- Partnership's holding period will tack on to the transferee-partner holding period.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

36

## Ordering of Distributions

1. Cash, including relief of liabilities, and the fair market value of marketable securities
2. IRC §751 ("hot" assets)
3. Other non-IRC §751 property (i.e. land)

Outside basis is affected by these distributions in the order above.

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

37

## Current Distribution Examples

Partner Basis in Interest: \$5,000

Example 1-Cash Distribution \$6,000

-Gain \$1,000 recognized

Example 2-Equipment Tax Basis of \$7,000

-\$2,000 gain on not recognized; however,  
equipment only has basis of \$5,000

*A Legacy of Loyalty*



Briggs & Veselka Co.  
CPAs and Business Advisors

38

## Liquidating Distribution Examples

Partner Basis in Interest: \$5,000


Example 1-Cash Distribution \$1,200 , Equipment at  
Tax Basis \$3,000

-No capital loss but basis in equipment is  
\$3,800 (\$3,000+\$800 loss not recognized)

Example \$4,000 of inventory

-Recognize \$1,000 capital loss (property remains  
ordinary income property for 5 years)

*A Legacy of Loyalty*



39

**Briggs & Veselka Co.** Tax Cut & Jobs Act effects  
CPAs and Business Advisors

---

199A/QBI-No impact on basis


163(j)-Interest Expense Limitation DOES decrease basis

The carryover is tracked at partner level and the Adjusted Taxable Income is computed at partnership level to determine utilization (consider gain upon disposition, 704(c) allocations, 734(b) allocations)

Excess Business Losses-Section 461 (still lower basis), extra hurdle to utilize losses

---

*A Legacy of Loyalty*



40

**Briggs & Veselka Co.** New Items K-1  
CPAs and Business Advisors

---

**G**  General partner or LLC member-manager       Limited partner or other LLC member

**H1**  Domestic partner       Foreign partner

**H2**  If the partner is a disregarded entity (DE), enter the partner's:  
 TIN \_\_\_\_\_ Name \_\_\_\_\_

**I1** What type of entity is this partner? \_\_\_\_\_

**I2** If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here

**J** Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	%	%
Loss	%	%
Capital	%	%

Check if decrease is due to sale or exchange of partnership interest


**K** Partner's share of liabilities:

	Beginning	Ending
Nonrecourse . . . . \$	\$	\$
Qualified nonrecourse financing . . . . \$	\$	\$
Recourse . . . . \$	\$	\$

Check this box if Item K includes liability amounts from lower tier partnerships.

---

*A Legacy of Loyalty*



41

**Briggs & Veselka Co.** New Items K-1  
CPAs and Business Advisors

---

Check this box if Item K includes liability amounts from lower tier partnerships.

L Partner's Capital Account Analysis							
Beginning capital account . . . . \$ _____	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">14</td> <td style="width: 70%;">Self-employment earnings (loss)</td> <td style="width: 25%;"></td> </tr> <tr> <td colspan="2"></td> <td style="background-color: #cccccc;"></td> </tr> </table>	14	Self-employment earnings (loss)				
14		Self-employment earnings (loss)					
Capital contributed during the year . . . . \$ _____							
Current year net income (loss) . . . . \$ _____							
Other increase (decrease) (attach explanation) \$ _____							
Withdrawals & distributions . . . . \$ ( _____ )							
Ending capital account . . . . \$ _____							
<p>M Did the partner contribute property with a built-in gain or loss?  <input type="checkbox"/> Yes <input type="checkbox"/> No If "Yes," attach statement. See instructions.</p>							
<p>N Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%;">Beginning . . . . .</td> <td style="width: 45%;">\$ _____</td> <td style="width: 50%;"></td> </tr> <tr> <td>Ending . . . . .</td> <td>\$ _____</td> <td></td> </tr> </table>		Beginning . . . . .	\$ _____		Ending . . . . .	\$ _____	
Beginning . . . . .	\$ _____						
Ending . . . . .	\$ _____						


21  More than one activity for at-risk purposes\*

22  More than one activity for passive activity purposes\*

\*See attached statement for additional information.

For IPS Use Only

*A Legacy of Loyalty*



42

**Briggs & Veselka Co.** Things to be aware of  
CPAs and Business Advisors

---

Other things to consider outside the scope of basic course

- Pre-contribution gain/loss 704(c)
- 754 elections-outside basis exceeds inside basis of assets
- Reg 1.705-1(b)-Alternative rule to determine basis
- Disguised Sales-Part sale part contribution

*A Legacy of Loyalty*



## Questions?

Michelle Mullen, Tax Partner  
713-667-9147  
mmullen@bvccpa.com

