

## LB&I Concept Unit Knowledge Base – S Corporations

Library Level	Number	Title
Shelf	–	Other Flow-Throughs
Book	53	S Corporation
Chapter	53.4	Stock & Debt Basis
Section	53.4.1	Stock Basis
Subsection	53.4.1.1	Initial Stock Basis

<b>Unit Name</b>	Initial Stock Basis	
<b>Primary UIL Code</b>	1367.00-00	Adjustment to Basis of Stock of, and Indebtedness Owing, Shareholders

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# Table of Contents

*(View this PowerPoint in “Presentation View” to click on the links below)*

[General Overview](#)

[Detailed Explanation of the Concept](#)

[Examples of the Concept](#)

[Index of Referenced Resources](#)

[Training and Additional Resources](#)

[Glossary of Terms and Acronyms](#)

[Index of Related Practice Units](#)

# General Overview

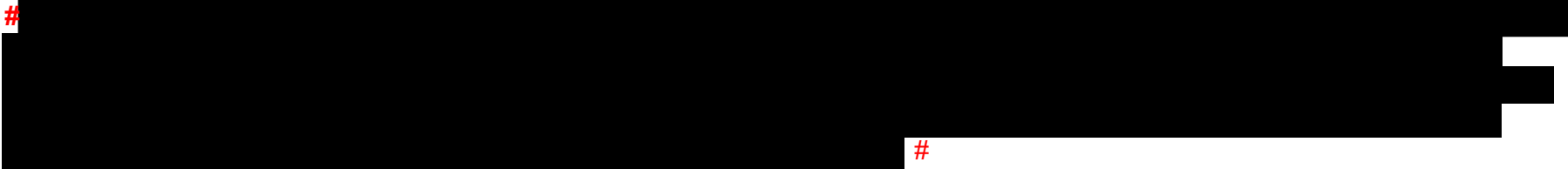
## Initial Stock Basis

Shareholders must establish the amount of their stock basis when:

- The S corporation allocates a loss or deduction item to the shareholder,
- The S corporation makes a non-dividend distribution to the shareholder, or
- The shareholder sells, exchanges, or otherwise disposes of stock.

### Requirement to Track Basis

Shareholders are required to keep track of their individual basis in the S corporation. The requirement to keep books and records is contained in Treas. Reg. 1.6001-1(a). Specifically, S corporation shareholders are required to maintain adequate books and records to substantiate their basis. Taxpayers who do not maintain adequate recordkeeping bear the burden of proof to show they had sufficient basis to deduct their claimed losses. See e.g., *Welch v. Comm'r* - T.C. Memo. 2012-179.



### Requesting Basis Computations During the Corporate Exam

Tracking stock and debt basis is the shareholder's responsibility and not the corporation's responsibility. However, often stock basis and debt basis are tracked at the corporate level when the S corporation is closely held. In this case, the examiner may request both stock and debt basis computations for the S corporation's shareholders during the corporate examination. Receiving the basis computation from the corporation does not constitute an examination of the shareholder's return. However, if the examiner requests verification of the basis amounts or questions the computation provided, the examination should be expanded to include the shareholder's return.

# General Overview (cont'd)

## Initial Stock Basis

### Requesting Basis Computations During the Corporate Exam (cont'd)

If the corporation does not provide the stock and debt basis computations, then the examiner should initiate an examination of the individual shareholder's return and request the basis computation from the shareholder. # [REDACTED]

#

The rules for determining initial basis in S corporation stock and C corporation stock are the same. However, the rules for adjusting basis after the initial acquisition differ considerably.

The most common ways to acquire stock are:

- Stock Purchase - The initial stock basis for purchased stock is the amount paid. IRC 1012.
- IRC 351 Transfer - The initial stock basis is computed by taking the carryover basis of assets transferred to the corporation, less the liabilities assumed by the corporation. IRC 358(a).
- Gift - The initial basis in stock received as a gift is the donor's basis just prior to the gift, adjusted for gift tax paid by the donor, if any. IRC 1015(d)(6). For example, if father gives stock to his son, the son's basis would be the father's basis at the date of the gift.
- Inheritance - Generally the initial basis equals the fair market value (FMV) of the stock at the date of death, or alternate valuation date, as recognized by the estate. IRC 1014.
- Compensation - The initial stock basis for stock received as compensation is the FMV on the date the compensation is included in the recipient's income. Treas. Reg. 1.83-4(b); IRC 1012.


# Detailed Explanation of the Concept

## Initial Stock Basis


The initial stock basis for purchased stock is the amount paid.

Analysis	Resources
<p><u>Acquisition of Stock Using a Note</u></p> <p>When stock is purchased using a note, the purchaser's cost equals the purchase price, even though the shareholder has not fully paid for the stock.</p> <p>This is true even when the purchase of stock is between related parties and even when the related party seller recognizes the gain on the installment method. Although the related party seller reports the gain over time under the installment method, the related party purchaser is entitled to stock basis equal to the full purchase price, assuming the purchase price does not exceed the FMV.</p> <p>Although the shareholder may receive basis, the individual shareholders must still establish that they are sufficiently at risk before claiming losses or deductions. Under the at-risk rules, a shareholder is not considered at risk for amounts borrowed from a person having an interest in the activity (i.e., another shareholder), other than as a creditor. For more on at-risk limitations see S Corporation Shareholder Loss Limitations Issue Guide.</p>	<ul style="list-style-type: none"><li>▪ IRC 1012</li>          <li>▪ IRC 465(b)(3)</li><li>▪ Audit Tool - S Corporation Shareholder Loss Limitation Issue Guide</li></ul>

# Detailed Explanation of the Concept (cont'd)

Initial Stock Basis	
Analysis	Resources
<p><u>Acquisition of Stock Using a Note (cont'd)</u></p> <p>Exception: Shareholders do not increase their S corporation stock basis by contributing their own note. Therefore, if the shareholder purchases stock from the S corporation using a note, the shareholder does not obtain stock basis until payments on the note are made.</p> <p> <b>CAUTION:</b> A shareholder may attempt to increase his stock basis by a stock subscription receivable with the S corporation. In a stock subscription receivable, the shareholder gives a corporation a note payable in exchange for corporate stock. The shareholder does not get stock basis until the payments are made.</p>	<ul style="list-style-type: none"><li>▪ Rev. Rul. 81-187</li></ul>

# Detailed Explanation of the Concept (cont'd)

Initial Stock Basis	
Analysis	Resources
<p><u>Bargain Purchase of Stock (Part Gift - Part Sale Transaction)</u></p> <p>It is quite common for a shareholder to sell his stock to a family member. A shareholder who sells the stock to a family member for less than FMV, partially gifts the stock. The amount of the gift equals the difference between the actual amount paid and the FMV of the stock. See Treas. Reg. 1.1001-1(e) for examples.</p> <p>The buyer's/recipient's basis in the purchased stock is the greater of the amount paid for the stock or the seller's adjusted basis in the stock, increased by the gift tax paid, if any. However, there is a special rule for determining losses on a subsequent sale of the stock. If the recipient's basis equals the seller's adjusted basis and the recipient later sells the stock at a loss, his unadjusted basis in the stock shall not be greater than the FMV at the time of such transfer.</p> <p>For purposes of determining gain from the part sale – part gift transaction, the entire stock basis of the seller/transferor is allocated to the stock sold and offsets the amount realized from the sale in computing the gain/loss. However, as the stock was sold to a family member, no loss is allowed when the basis exceeds the amount realized. If the shareholder claimed a loss, it should be disallowed.</p> <p> # [REDACTED] #</p>	<ul style="list-style-type: none"><li>▪ Treas. Reg. 1.1001-1(e)</li><li>▪ Treas. Reg. 1.1015-4</li><li>▪ Treas. Reg. 1.1015-5</li><li>▪ Treas. Reg. 1.1001-1(e)(1)</li></ul>

# Detailed Explanation of the Concept (cont'd)

Initial Stock Basis	
Analysis	Resources
<p><u>Basis of Stock Received by Gift</u></p> <p>The recipient's basis in the property acquired by gift is equal to the donor's basis. However, there is a special rule for determining losses on a subsequent sale of the stock. If the donor's basis was greater than the FMV at the time of gift and recipient later sells the stock at a loss, his stock basis equals the FMV at the time of the gift.</p> <p>In this situation, the recipient's initial basis in the gifted stock is not determinable until the stock is sold. If the recipient sells the gifted stock at a gain, the higher donor's adjusted basis amount is used as the stock's basis. If the recipient sells the gifted stock at a loss, the lower FMV is used as the stock's basis. Finally, if the gifted stock is sold for an amount between the donor's adjusted basis and the FMV at the date of gift, the stock's basis equals the sales price and no gain or loss is recognized on the sale.</p> <p>Since gifted stock basis is not determinable when the adjusted basis is greater than the FMV at the date of the gift, it leaves the question of what stock basis is used for S corporation loss allocation purposes. Treas. Reg. 1.1366-2(a)(6) provides that the basis of stock acquired by gift for purposes of determining if a shareholder's losses exceed his basis is equal to the lesser of the donor's adjusted basis or the FMV at the date of gift.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.1015-1</li>   <li>▪ Treas. Reg. 1.1015-1(a)(2)</li>   <li>▪ Treas. Reg. 1.1366-2(a)(6)</li> </ul>



# Detailed Explanation of the Concept (cont'd)

Initial Stock Basis	
Analysis	Resources
<p><u>Income in Respect of a Decedent</u></p> <p>The initial basis of inherited stock generally equals the FMV at the date of death, or at an alternative valuation date if elected. However, the basis is reduced to the extent the value of the stock is attributable to items consisting of income in respect of a decedent (IRD).</p> <p>IRD is income the decedent had a right to receive or accrue at the time of death that was not included on the decedent's final income tax return. Instead, the IRD is included on the decedent's estate tax return and it is reportable as income by the beneficiary when received. Examples include income from an installment sale and interest on an investment which is due but had not been paid as of the date of death. See <a href="#">Examples of the Concept</a> slide.</p> <p>Life insurance proceeds are not considered IRD. Therefore, the insurance proceeds do not reduce the FMV of the S corporation stock at the date of death.</p> <p>Special rules applicable to 2010. The Economic Growth and Tax Relief Reconciliation Act of 2001 repealed estate tax for 2010, however the Tax Relief Act of 2010 restored estate taxes, but allowed estates of decedents who died in 2010 to elect out of estate tax and take a carryover basis under IRC 1022. Therefore, if a decedent's estate pays estate tax, the rules described above apply in determining the beneficiary's initial stock basis, but if the decedent's estate elects out then the beneficiary is entitled to a carryover basis.</p>	<ul style="list-style-type: none"><li>▪ IRC 1014</li><li>▪ IRC 1367(b)(4)</li></ul>


# Detailed Explanation of the Concept (cont'd)

Initial Stock Basis	
Analysis	Resources
<p><u>Stock Received in Exchange for Services</u></p> <p>S corporation employees may receive stock in the S corporation in exchange for services. The S corporation includes the FMV of the stock in the employee's wages reported on Form W-2 and the S corporation may deduct the wage expense. The employee-shareholder reports this amount in income as a wage. Additionally, that amount is the employee-shareholder's initial stock basis equals the FMV as included on Form W-2.</p> <p>In certain situations, instead of the S corporation issuing new stock to the employee, another shareholder may transfer some of his stock to an employee as compensation for services. In that case, the existing shareholder is deemed to contribute property to the capital of the S corporation and immediately thereafter, the S corporation transfers the stock to the employee.</p>	<ul style="list-style-type: none"><li>▪ IRC 83(h)</li><li>▪ Treas. Reg. 1.83-6(d)(1)</li></ul>

# Detailed Explanation of the Concept (cont'd)

Initial Stock Basis	
Analysis	Resources
<p><u>Conversion from C Corporation to S Corporation</u></p> <p>When a corporation converts from a C corporation to an S corporation, the shareholder's C corporation stock and debt basis becomes the shareholder's S corporation stock and debt basis.</p> <p>Generally a shareholder's basis in C corporation stock does not change while the entity is a C corporation. However, a shareholder's stock basis increases with additional stock purchases and additional capital contributions; and decreases for distributions not taxed as a dividend (return of capital). Debt basis increases when a shareholder lends additional funds to the corporation and decreases by any loan repayments.</p>	<ul style="list-style-type: none"><li>▪ IRC 1012</li><li>▪ IRC 1016</li><li>▪ Treas. Reg. 1.1016-5</li></ul>

# Detailed Explanation of the Concept (cont'd)

Initial Stock Basis	
Analysis	Resources
<p><u>Conversion from Partnership to S Corporation</u></p> <p>When a partnership or LLC taxed as a partnership converts to an S Corporation, the following steps are deemed to occur:</p> <ol style="list-style-type: none"><li>1. The partnership transfers all of its assets to a newly formed corporation in exchange for all of the corporate stock.</li><li>2. The partnership liquidates and distributes the corporate stock to the partners.</li><li>3. The partners' (now shareholders') basis in the S corporation stock is now equal to the partners' basis in the partnership interest immediately before the partnership liquidation, less any liabilities transferred to the S corporation, plus any gain recognized.</li></ol> <p> <b>CAUTION:</b> If the partnership liabilities exceed the adjusted basis of the assets, there is a recognized gain under IRC 357(c). See the S Corporation Corporate Issues and Advanced Topics Issue Guide for more information.</p>	<ul style="list-style-type: none"><li>▪ Rev. Rul. 2004-59</li><li>▪ Treas. Reg. 301.7701-3</li> <li>▪ Audit Tool – S Corporation Corporate Issues and Advanced Topics Issue Guide</li></ul>

# Examples of the Concept

## Initial Stock Basis

### Examples

#### Income in Respect of a Decedent Example

The 100% shareholder of an S corporation dies July 1, 2012. As of July 1st the S corporation has an installment contract with \$200,000 of remaining unreported installment sales gain. The FMV of the S corporation's stock at the date of death is \$1M.

The estate or beneficiary of the decedent would have a basis in the S corporation stock of \$800,000 (\$1M – 200,000 IRD).

When the S corporation subsequently collects the installment proceeds and reports the \$200,000 installment sale gain, that income is allocated to the estate or beneficiary shareholder and the shareholder's stock basis is increased from \$800,000 back up to \$1M.

# Index of Referenced Resources

<b>Initial Stock Basis</b>
IRC 83(h)
IRC 351
IRC 358(a)
IRC 465(b)(3)
IRC 1367(b)(4)
IRC 1012
IRC 1014
IRC 1015(d)(6)
IRC 1016
Treas. Reg. 1.83-4(b)
Treas. Reg. 1.83-6(d)(1)
Treas. Reg. 1.1001-1(e)
Treas. Reg. 1.1015-1
Treas. Reg. 1.1015-4
Treas. Reg. 1.1015-5
Treas. Reg. 1.1016-5

# Index of Referenced Resources (cont'd)

## Initial Stock Basis

Treas. Reg. 1.1366-2(a)(6)

Treas. Reg. 301.7701-3

Rev. Rul. 81-187

Rev. Rul. 2004-59

*Welch v. Comm'r* - T.C. Memo. 2012-179

# Training and Additional Resources

Initial Stock Basis	
Type of Resource	Description(s)
Saba Meeting Sessions	<ul style="list-style-type: none"><li>▪ <i>Overview of S Corp Stock Basis - 2014 Centra</i></li></ul>
Issue Toolkits	<ul style="list-style-type: none"><li>▪ Audit Tool – S Corporation Corporate Issues and Advanced Topics Issue Guide</li><li>▪ Audit Tool - S Corporation Shareholder Loss Limitation Issue Guide</li><li>▪ Audit Tool – S Corporation Stock &amp; Debt Issue Guide</li><li>▪ Audit Tool - Stock &amp; Debt Basis Worksheet Tools</li><li>▪ Audit Tool - FAQs – Basis &amp; Loss Limitations</li><li>▪ Issue Snapshot - Determining a Shareholder's Initial Stock Basis</li></ul>
Reference Materials	<ul style="list-style-type: none"><li>▪ <i>Practitioners Publishing Company (PPC) - 1120S Deskbook</i></li></ul>



# Glossary of Terms and Acronyms

Term/Acronym	Definition
EUP	Employee User Portal
FMV	Fair Market Value
IRD	Income in Respect of a Decedent

# Index of Related Practice Units

<b>Associated UIL(s)</b>	<b>Related Practice Unit</b>	<b>DCN</b>
1367.00-00	<i>Adjustments to Stock Basis</i>	SCO/C/53_4_1_2-02(2016)
1367.01-00	<i>Stock Basis Ordering Rules</i>	SCO/C/53_4_1_3-03(2016)
1367.02-00	<i>Valid Shareholder Debt Owed by S Corporation</i>	SCO/C/53_4_2_1-04(2016)
1367.00-00	<i>Adjustments to Debt Basis</i>	SCO/C/53_4_2_2-05(2016)