Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Concept Unit
Knowledge Base – S Corporations

Library Level	Number	Title
Shelf		Other Flow-Throughs
Book	53	S Corporations
Chapter	53.4	Stock & Debt Basis
Section	53.4.1	Stock Basis
Subsection	53.4.1.2	Adjustments to Stock Basis

Unit Name	Adjustments to Stock Basis	
Primary UIL Code	1367.01-00	Adjustment to Basis of Stock of, and Indebtedness Owing, Shareholders

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General Overview

Adjustments to Stock Basis

Adjustments to stock basis are taken into account at the end of the year, except when stock is sold or otherwise disposed of during the year. Shareholders increase their stock basis by their additional capital contributions and by their pro-rata share of the following items as reported on Form 1120S, Schedule (Sch.) K-1 (using 2016 Sch. K-1 items):

1. Ordinary income (Box 1)
2. Separately stated income items (Boxes 2 to 10)
3. Tax-exempt income (Boxes 16(A & B))
4. Excess depletion (Box 17(R))

Shareholders' stock basis is decreased, but not below zero by the following items reported on Sch. K-1:

1. Ordinary loss (Box 1)
2. Separately stated loss items (Boxes 2 to 12 (A to P. & S and 14)L&M))
3. Non-deductible expenses (Boxes 16(C))
4. Non-dividend distributions (Box 16(D))
5. Depletion for oil and gas (Box 17(R))

Note: Only non-dividend distributions impact stock basis; dividend distributions from earnings and profits do not.

See Example of the Concept #1.

Detailed Explanation of the Concept

Adjustments to Stock Basis
An S corporation shareholder’s stock basis is increased by items of income and excess depletion, and decreased by distributions, items of loss and deductions, non-deductible expenses, and depletion for oil and gas.

Analysis	Resources
Income Not Claimed A shareholder who fails to report items of S corporation income may not increase stock basis by those amounts. This concept is reflected in the phrase "only to the extent such amount is included in the shareholder's gross income." However, when a return is not required to be filed, shareholder stock basis is still increased by the income. Losses Not Claimed Basis is reduced even if the shareholder neglects to claim the S corporation loss or deduction. Basis is also reduced if the shareholder derives no tax benefit from the loss. Finally, basis is reduced even if the shareholder must defer the loss due to other loss limitations, for example, a passive activity loss. See Example of the Concept #2. The pass through of a loss item is prorated at the end of the year. Thus, the reduction in the stock's basis extends to all shares held throughout the year. The basis of each share is reduced by the portion of the shareholder's pro rata allocation of the corporation's loss item attributable to that share. See Example of the Concept #3.	▪ IRC 1367(b)(1) ▪ IRC 1367(a)(2)(B) ▪ IRC 1367(a)(2)(C) ▪ IRC 1367(a)(2)(E) ▪ IRC 1366(a)(1) ▪ *Barnes v. Comm’r* - 712 F.3d 581 (D.C. Cir. 2013)

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Detailed Explanation of the Concept (cont'd)

Adjustments to Stock Basis

Analysis	Resources
Life Insurance Premiums Non-deductible expenses passed through an S corporation reduce the shareholders' stock basis. This includes the cost of non-deductible life insurance premiums in which an S corporation purchases life insurance on a shareholder or key employee and the S corporation is also the policy's direct or indirect beneficiary. In this case, the life insurance premiums are not deductible and any insurance proceeds are not includible in income. The above rule has to be modified if the insurance policy generates a cash surrender value (CSV). If the insurance policy includes an investment portion, such as a whole life policy, only the portion attributable to purchasing the death benefit should be used to reduce the shareholder's stock basis. The S corporation should have a statement from the insurance company breaking down the premiums paid between the portion paid for the CSV and the amount paid for the death benefit. Again, though the entire premium is not deductible for income tax purposes, only the premium portion paid for the death benefit should be treated as a non-deductible expense that reduces stock basis. A practical approach to allocating the premiums between the insurance and investment features of the policy, when not provided in the policy, is to treat the portion of the premium equal to the increase in the cash surrender value associated with that premium as the amount attributable to the investment feature, and the remaining portion of the premium attributable to the insurance coverage. See Examples of the Concept #4.	▪ IRC 1367(a)(2) ▪ IRC 264(a)(1) ▪ IRC 101(a)(1)

Detailed Explanation of the Concept (cont'd)

Adjustments to Stock Basis	
Analysis	**Resources**
Life Insurance Premiums (cont'd**)** As life insurance policies mature, the cash surrender value may increase more than the annual premium. The excess of the current year CSV increase over the current year premium does not increase stock basis as non-taxable income. The CSV is only non-taxable at the death of the insured. If the S corporation cancels the insurance policy and receives the CSV, the amount of the CSV received by the S corporation that exceeds the total prior premiums is taxable income to the S corporation. The character of the income is ordinary income as it is not considered a gain on sale of a capital asset. If the prior premiums exceed the CSV, the S corporation is not allowed a loss. Rev. Rul. 2009-13 describes three situations in which an insurance policy is cashed in or sold. When a policy is sold, the gain can be part ordinary and part capital depending on the sale price. If the gain on sale of the policy is greater than the income reportable by cashing in the policy, the excess is characterized as capital gain.	▪ Rev. Rul. 2009-13 – Sale or Surrender of Life Insurance Contract

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Adjustments to Stock Basis</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>Life Insurance Proceeds Affect on Stock Basis</u>

Many S corporations have stock buy-sell or redemption agreements that permit an S corporation to purchase a deceased shareholder's stock. For example, if there are three unrelated shareholders and one dies, the remaining two shareholders may wish to prevent the deceased's spouse or other heir from becoming a shareholder. To ensure that funds are available for a stock buy out, the S corporation purchases life insurance policies on each shareholder.

Any life insurance proceeds received by the S corporation are characterized as tax-exempt income, assuming the S corporation did not expense the life insurance premiums in prior years. Tax-exempt income, including life insurance proceeds, increases a shareholder's stock basis. However, when an S corporation has multiple shareholders, the following factors are used to determine which shareholders' stock basis is increased and by how much:

▪ the S corporation's method of accounting, i.e., cash or accrual,
▪ the date the life insurance proceeds were received, and
▪ the method of income allocation (per/share-per/day or closing of the books).

Depending on the answers to the above items, there could be a double stock basis benefit for life insurance owned by an S corporation.</td><td>▪ IRC 101
▪ IRC 1367\(a)(1)(A)</td></tr>
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Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Adjustments to Stock Basis</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>Life Insurance Proceeds Affect on Stock Basis (cont'd)</u>

The S corporation's method of accounting determines when the tax-exempt life insurance proceeds are considered earned and thus which shareholder's S corporation stock basis is increased by the tax-exempt income.

A cash basis S corporation would report the tax-exempt income on the day the insurance proceeds were received, whereas, an accrual basis S corporation would report the tax-exempt income when accrued which is the date of death. The tax exempt income is then allocated to the shareholders under one of two methods:

1. Per/share-per/day or
2. Closing of the books

Under the per/share-per/day method, the S corporation income is allocated to each shareholder based on the number of shares held and the number of days the stock was held.

Under the closing of the books method, the S corporation closes the books on the day a shareholder disposes of all of his stock as described in the buy-sale agreement. The deceased shareholder is allocated the income for the period before the closing of the books and the new shareholder is allocated the income for the period after the closing of the books.</td><td>▪ PLR 200409010 - General Rule for Taxable Year of Inclusion
▪ Audit Tool - S Corporation Operations Issue Guide</td></tr>
</table>

Detailed Explanation of the Concept (cont'd)

Adjustments to Stock Basis	
Analysis	**Resources**
<u>The Effect of Credits on Stock Basis</u> Generally, a shareholder may claim credits passed through from an S corporation regardless of the shareholder's stock or debt basis. However, there are two situations in which claiming the credit decreases basis: 1. Credits which require a reduction of an expense, and 2. Credits which require a reduction in the basis of an asset. An example of the first category is the Research Credit, which requires the taxpayers who elect the Research Credit to reduce the research and experimental expenditures by the amount of the credit. That requirement creates a non-deductible expense at the S corporation level that passes through to the shareholders and the non-deductible expense reduces the shareholder's basis. An example of the second category is the New Markets Tax Credit, which requires taxpayers to reduce the basis of their investment asset and reduce the basis in the their S corporation stock. Unlike the first category, this requirement does not create a non-deductible expense at the S corporation level, therefore the taxpayers must remember to adjust their stock basis.	▪ IRC 50(c)(1) ▪ IRC 50(c)(5) ▪ Treas. Reg. 1.45D-1(f)(2)

Detailed Explanation of the Concept (cont'd)

Adjustments to Stock Basis	
Analysis	**Resources**
<u>Foreign Tax Credits</u> A U.S. taxpayer who earns income in a foreign country is taxed in both the foreign country and in the U.S. on that income. In order to prevent double taxation, the taxpayer is allowed either a foreign tax credit (FTC) or a deduction for foreign taxes paid. When an S corporation pays tax to a foreign country, the foreign tax paid or accrued is reported on the Form 1120S, Sch. K, Line 14l and on the Sch. K-1, Box 14L or M. The foreign taxes paid are passed through to the shareholder(s). The shareholder may either deduct the foreign taxes paid on the Form 1040, Sch. A or elect to claim a FTC. If the shareholder elects a FTC, he computes the credit on Form 1116, *Foreign Tax Credit*. The amount of foreign tax paid or accrued decreases a shareholder's basis.	▪ Form 1120S - *U.S. Income Tax Return for an S Corporation* ▪ Form 1120S, Schedule K-1 - *Shareholder's Share of Income, Deductions, Credits, etc.* ▪ Form 1040, Schedule A - *Itemized Deductions* ▪ Form 1116, *Foreign Tax Credit*

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Adjustments to Stock Basis</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>Basis Adjustment for Certain Tax Credit Bonds</u>

Organizations or entities such as state and local governments, qualified non-profit organizations, and tax-exempt electricity providers are allowed to issue tax credit bonds to finance and incentivize certain activities. Issuing a tax credit bond benefits the organization because no interest or reduced interest is paid on its outstanding bonds. Additionally, the tax credit bond holder receives a tax credit instead of some or all of the interest.

The Code provides for a number of tax credit bonds:

1. Clean renewable energy bonds,
2. Qualified zone academy bonds (QZABs) issued before 10/4/2008,
3. Gulf credit bonds,
4. Build America bonds, and
5. Qualified tax-credit bonds, which encompass:
a. Qualified forestry conservation bonds;
b. QZABs issued after 10/3/2008;
c. New clean energy conservation bonds;
d. Qualified energy conservation bonds; and
e. Qualified school construction bonds.</td><td>▪ IRC 54
▪ IRC 54E
▪ IRC 1400N
▪ IRC 54AA
▪ IRC 54A
▪ IRC 54B
▪ IRC 54E
▪ IRC 54C
▪ IRC 54D
▪ IRC 54F</td></tr>
</table>

Detailed Explanation of the Concept (cont'd)

Adjustments to Stock Basis	
Analysis	**Resources**
Basis Adjustment for Certain Tax Credit Bonds (cont'd) Although the holder of the tax credit bond did not receive some or all of the interest, the holder must still include the amount of the credit claimed in interest income. The net effect is that the holder gets a credit of, say, $100 to use against tax. Assuming a 25 percent tax rate, the holder would be able to use the credit to offset $400 of income. But the holder has to include interest income equal to the credit. So, assuming a 25 percent tax rate, the holder would only be able to offset $300 of income (net of the $100 imputed income). For S corporations, and other pass-through entities, this causes a complication. The deemed interest income passes through to the shareholders, which would ordinarily result in an increase in stock basis. But since there is no actual cash associated with the stock basis increase, there can never be a distribution, so there could never be a corresponding decrease in basis. This results in a basis distortion that can be addressed in one of two ways: 1. deny the basis increase in the amount of the deemed interest income or 2. permit the basis increase but add a deemed distribution in the amount of the deemed interest income.	

Detailed Explanation of the Concept (cont'd)

Adjustments to Stock Basis	
Analysis	**Resources**
<u>Basis Adjustment for Certain Tax Credit Bonds (cont'd)</u> For S corporations, Congress has employed each of the two approaches. Under the first approach (applicable to "type-1 bonds"), the credit amount is treated as deemed interest income, however the corresponding basis increase is disallowed. This approach disallows the basis increase for the deemed interest income because there is no corresponding distribution. Allowing the basis increase without a corresponding decrease would artificially inflate basis. This approach applies to the clean renewable energy bonds, Gulf tax credit bonds, Midwestern tax credit bonds, and QZAB credit for bonds issued before 10/4/2008. The second approach (for "type-2 bonds") applies the normal rule of IRC 1367(a)(1) that pass-through income increases the shareholder's stock basis, so the deemed interest income increases basis. However, under this approach the amount of the credit is treated as a deemed distribution that generally decreases basis. This approach applies to each of the qualified tax credit bonds (qualified forestry conservation bonds, qualified zone academy bonds issued after 10/3/2008, new clean renewable energy bonds, qualified energy conservation bonds and qualified school construction bonds) and Build America Bonds.	▪ IRC 54(l)(3)(B) ▪ IRC 1400N(l)(7)B)(ii) ▪ Pub. L. 110-343 Div. C, sec. 702 (2008) ▪ IRC 1397E(l)(2) ▪ IRC 54A(g) ▪ IRC 54AA(f)(2) ▪ IRC 1367(a)(1)

Detailed Explanation of the Concept (cont'd)

Adjustments to Stock Basis	
Analysis	**Resources**
Basis Adjustment for Certain Tax Credit Bonds (cont'd) Ordinarily, whether a tax-credit bond is a type-1 or type-2 bond is irrelevant for basis purposes. Both methods have a neutral impact on stock basis – under the first method, the increase and decrease is ignored, while under the second method, the deemed income and deemed distribution offset each other. See Examples of the Concept #5,6, 7. However, when an S corporation has losses and deductions that exceed income, the method may affect the shareholder's taxable distributions. For an S corporation with accumulated earnings and profits (AE&P), the two methods for the two different kinds of credits may have different effects because the ordering rules for tracking the Accumulated Adjustments Account (AAA) differ from the ordering rules for stock basis. Adjustments are made to the AAA in a manner similar to the adjustments for stock basis. For the type-1 bonds (that are treated under the no-basis-increase-and-no-deemed-distribution rule), there is no increase to the AAA for the deemed interest income that passes through to the shareholder. For the type-2 bonds (that are treated under the basis-increase-but-deemed-distribution rule), AAA is increased by the amount of deemed interest income that passes through to the shareholder. As long as the increases equal or exceed the decreases in both situations, type-1 and type-2 credits should have the same effect. However, where there is a net negative adjustment in a case involving a type-1 credit, there might not be a net negative adjustment in a case involving a type-2 credit. The resulting treatment of distributions may, therefore, differ. See Examples of the Concept #5,6, 7.	▪ IRC 1368(e)(1)(A) ▪ IRC 1367 ▪ Audit Tool – S Corporations Distributions Issue Guide

Detailed Explanation of the Concept (cont’d)

Adjustments to Stock Basis	
Analysis	**Resources**
<u>Stock Basis and the Domestic Production Activities Deduction</u> Taxpayers are allowed to claim a Domestic Production Activities Deduction (DPAD) for qualified production activities. In the case of a taxpayer that is an S corporation, DPAD is claimed at the shareholder level, not the S corporation level. The allowable deduction may be impacted when the shareholder does not have adequate stock or debt basis. Although the amount of the DPAD deduction may be limited when there is a basis limitation, the allowable DPAD deduction has no effect on the adjusted basis of a shareholder’s stock in an S corporation. As, the shareholder computes the allowable DPAD based upon the information supplied, the S corporation is responsible for providing the necessary information to its shareholder(s) on their Sch. K-1 for the shareholder’s allocable share of the IRC 199 Domestic Production Activities.	▪ Treas. Reg. 1.199-5(c)(1) ▪ Treas. Reg. 1.199-5(c)(2)

Detailed Explanation of the Concept (cont'd)

Adjustments to Stock Basis	
Analysis	**Resources**
<u>Depletion</u> There are two types of depletion, cost depletion and percentage depletion. Cost depletion is similar to depreciation in that the S corporation would expense the cost of the depletable asset over time. Percentage depletion is, in very simplistic terms, a percentage of sales. Percentage depletion is unique in that it allows a taxpayer cumulative depletion expense deductions which can exceed the basis of the depletable asset. Due to the excess benefit of percentage depletion, in order for S corporation's shareholders to utilize the benefit, a basis increase is allowed. The manner in which an S corporation reports depletion depends on the type of depletable asset. The following is a brief summary of the reporting requirements. 1. Depletion other than oil and gas - Depletion deduction is calculated by the S corporation and is claimed as part of ordinary income. - It is a tax preference item for Alternative Minimum Tax (AMT) purposes and is reported on line 15c of Sch. K and box 15, code C, of Sch. K-1. The S corporation should provide an attachment to the Sch. K-1 showing the details relating to calculating the tax preference amount.	▪ IRC 1367(a)(1)(C) ▪ Form 1120S - *U.S. Income Tax Return for an S Corporation* ▪ Form 1120S, Schedule K-1 - *Shareholder's Share of Income, Deductions, Credits, etc.*

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Adjustments to Stock Basis</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td>
<u>Depletion (cont'd</u>)

1. Depletion other than oil and gas (cont'd)

- Based on the unique percentage depletion basis rule, the shareholder is allowed to increase his basis by the amount that the shareholder's cumulative depletion deduction exceeds the shareholder's proportionate share of basis in the property subject to depletion.

2. Oil and gas depletion

- Depletion deduction is calculated by the shareholder, it is not an S corporation deduction. The shareholder's amount of depletion is subject to limitations.

- S corporation provides information on a property-by-property basis as an attachment to Sch. K-1, box 17 code R.

- S corporation also provides information to the shareholder to determine their tax preference items attributable for AMT on Sch. K-1 box 15, codes D and E.

The shareholder reduces stock and debt basis by the amount of oil and gas depletion claimed up to the shareholder's proportionate share of basis in the property subject to depletion. Any cumulative depletion in excess of the shareholder's proportionate share of basis in the property subject to depletion does not reduce the shareholder's stock and debt basis.
</td><td>
▪ Form 1120S, Schedule K-1 - Shareholder's Share of Income, Deductions, Credits, etc.
</td></tr>
</table>

Detailed Explanation of the Concept (cont'd)

Adjustments to Stock Basis	
Analysis	**Resources**
Cancellation of Debt Income Income from the discharge of indebtedness of an S corporation that is excluded from the S corporation's income is not taken into account as an item of income by any shareholder. Thus, the cancellation of debt income excludible under IRC 108(a) does not increase the shareholder's stock basis in the S corporation. Cancellation of debt that is includible in income is taxable to the shareholder and increases stock basis.	▪ IRC 108(d)(7) ▪ IRC 108(a) ▪ Audit Tool – S Corporations Corporate Issues & Advanced Topics Issue Guide

Detailed Explanation of the Concept (cont'd)

Adjustments to Stock Basis	
Analysis	**Resources**
IRC 179 and Stock Basis In 2005, Congress enacted the Energy Efficient Commercial Buildings Deduction, effective for property placed into service after 12/31/2005. As with any IRC 179 deduction, IRC 179D(e) holds that the basis of the property will be reduced by the IRC 179D deduction. IRC 179D(d)(4) provides for a deduction to designers of energy efficient commercial buildings owned by governmental agencies. Specifically, governmental agencies may allocate their deduction to designers. Consequently, this allows governmental agencies to negotiate a more favorable price because the designer is allowed an expense fund by the government. If the designer is an S corporation, the S corporation is allocated the deduction even though the S corporation does not own the building. The IRC 179D deduction is not associated with any S corporation asset. However, shareholders must reduce their stock and debt basis by the amount deducted on their individual tax returns. Because there is no specific basis exception for this deduction, the general rule that a shareholder's stock and debt basis is reduced by all pass-through loss and deduction items applies. See Examples of the Concept #8 & 9.	▪ IRC 179D ▪ Audit Tool - Energy Efficient Commercial Building Deduction IRC 179D ▪ Audit Tool - Energy Efficient Commercial Building IRC 179D – Technical Specifications v. Shop Drawings ▪ AM 2010007- Legal Advice Issued by Associate Chief Counsel - IRC 179D

Detailed Explanation of the Concept (cont'd)

Adjustments to Stock Basis	
Analysis	**Resources**
<u>Stock Basis and IRC 311 Loss</u>	
A shareholder who receives a property distribution treats the fair market value (FMV) of the property as the equivalent of cash received. The taxability of this distribution is determined like any other distribution, by the rules governing distributions. The shareholder's basis in the property received is its FMV. Also, the shareholder's stock basis is reduced by the amount of the non-taxable distribution.	▪ IRC 1368
At the S corporation level, the general rule is that no gain or loss is recognized by a corporation on its distribution of property to its shareholder. However, if the S corporation distributes property with a FMV greater than its adjusted basis, gain is recognized by the S corporation as if the property were sold at FMV. And if the S corporation distributes property with a FMV less than its adjusted basis, no loss is allowed to the S corporation.	▪ IRC 311(a) ▪ IRC 311(b)
The disallowable IRC 311(a) loss reduces a shareholder's stock basis similar to a non-deductible S corporation expense. In addition, the S corporation's AAA is also reduced.	▪ CCA 201421015 - IRC 311(a) ▪ Audit Tool – S Corporations Transactions with Shareholders Issue Guide

Examples of the Concept

Adjustments to Stock Basis

Examples

General Overview Example – Example 1

At the end of its taxable year, an S corporation's ordinary income was $29,000 and it had the following separately stated or non-deductible items:

Officer's Life Insurance Premiums	8,000	(Sch. K-1, Box 16(C))
Long-Term Capital Gain	5,000	(Sch. K-1, Box 8a)
Charitable Contributions	10,400	(Sch. K-1, Box 12(A))
Dividend Income	500	(Sch. K-1, Box 5a)

Adjustments made to the sole shareholder's stock basis would be as follows:

Item	Stock Basis Adjustments
Ordinary Income	29,000
Dividend Income	500
Long-Term Capital Gain	5,000
Officer's Life Insurance Premiums	(8,000)
Charitable Contributions	(10,400)
Net Increase to Shareholder's Stock Basis	16,000

Examples of the Concept (cont'd)

Adjustments to Stock Basis
Examples
<u>Losses Not Claimed - Example 2</u> Gary owns 40% of an S corporation. He does not actively participate in the S corporation's activity within the meaning of IRC 469. His share of the S corporation's loss for the year was ($8,000). Gary has no passive income during the year; therefore, he is not allowed to deduct the ($8,000) on his Form 1040 that year based on the passive activity rules. The passive activity loss is suspended and may be deducted in a later year. Even though Gary is not allowed to deduct the ($8,000) passive activity loss on his Form 1040 that year, his stock basis is still reduced by the ($8,000) loss. Note: if Gary is allowed to deduct the suspended passive activity loss in a later year, his stock basis will not need to be reduced in the year the passive activity loss is actually deducted. See the S Corporation Shareholder Loss Limitations Issue Guide for more on passive activity losses. <u>Losses Not Claimed - Example 3</u> Debbie owned 100 shares of an S corporation throughout 2012, which she purchased all at the same time for $50 per share, or $5,000. The S corporation had an ordinary loss for 2012, of which ($3,000) was Debbie's pro rata share. The basis of each share would be reduced by $30 ($3,000 divided by 100 shares) even if Debbie fails to claim the loss on her personal return.

Examples of the Concept (cont'd)

Adjustments to Stock Basis
Examples
<u>Life Insurance Premiums - Example 4</u> The S corporation purchases a whole life policy on its sole shareholder. During the taxable year, the corporation paid $8,000 in life insurance premiums. Also during the taxable year, the insurance policy's CSV increased by $3,000. Therefore, even though none of the $8,000 in premiums is deductible, stock basis is only reduced by $5,000 ($8,000 - $3,000). Once the annual CSV increase exceeds the annual premium expense, stock basis will not be reduced by the non-deductible premium expense.

Examples of the Concept (cont'd)

Adjustments to Stock Basis

Examples

Basis Adjustments for Certain Tax Credit Bonds – Example 5

An S corporation with a sole shareholder purchases a tax-credit bond. In Scenario A, the corporation purchases a qualified zone academy bond issued before October 4, 2008 (a type-1 bond); in Scenario B, the corporation purchases a qualified zone academy bond issued after October 3, 2008 (a type-2 bond). During the year, the corporation earns a credit of $100. The corporation also has ordinary income of $115 and a 1231 loss of $58. The corporation makes an actual distribution of $60. The shareholder has a beginning stock basis of $75. Assume the shareholder has income, loss, etc., only from the S corporation.

	Scenario A (Type-1)	Scenario B (Type-2)
Beginning stock basis	75	75
Increase for ordinary income	115	115
Increase for deemed interest income	0	100
Stock basis before distributions	190	290
Actual distribution	(60)	(60)
Deemed distribution	0	(100)
Stock basis before losses & deduction	130	130
1231 loss	(58)	(58)
Ending stock basis	72	72

In each case, the shareholder includes $215 ($115 + $100 deemed interest income) in gross income and deducts $58 of loss. For type-1 bonds, the deemed interest income does not increase stock or debt basis.

Examples of the Concept (cont'd)

Adjustments to Stock Basis

Examples

Basis Adjustments for Certain Tax Credit Bonds - Example 6

An S corporation with a sole shareholder purchases a tax-credit bond. In Scenario C, the corporation purchases a qualified zone academy bond issued before 10/4/2008 (a type-1 bond); in Scenario D, the corporation purchases a qualified zone academy bond issued after 10/3/2008 (a type-2 bond). The corporation earns a credit of $100. The corporation also has items of income (without regard to the tax-credit bond) of $115 from an IRC 1231 gain. The corporation has an ordinary loss of ($158) and makes an actual distribution of $60. The S corporation has beginning AAA of $50 and AE&P of $70. The shareholder has a beginning stock basis of $75. Assume the shareholder has income, loss, etc., only from the S corporation.

Scenario C is a case involving a net negative adjustment because the amount of reductions (other than distributions) ($158) exceeds the amount of increases of $115. Scenario D is not a case of involving a net negative adjustment, because the amount of the reductions (other than distributions) ($158) does not exceed the amount of the increases of $215 (115+100).

	Scenario C (Type-1)	Scenario D (Type-2)
Beginning AAA	50	50
Plus: 1231 gain	115	115
Plus: Deemed interest income	0	100
AAA before losses & deductions	165	265
Less: Ordinary Loss (limited for type-1)	(115)	(158)
AAA before distributions	50	107
Distribution (60/160; limited to AAA)	50	107
AAA before remaining loss	0	0
Remaining loss	(43)	0
Ending AAA	(43)	0

Examples of the Concept (cont'd)

Adjustments to Stock Basis

Examples

Basis Adjustments for Certain Tax Credit Bonds - Example 6 (cont'd)

	Scenario C (Type-1)	Scenario D (Type-2)
Total distribution	60	160
Non-dividend distribution from AAA	50	107
Dividend distribution from AE&P	10	53
Beginning AE&P	70	70
Dividend	10	53
Ending AE&P	60	17
Beginning stock basis	75	75
Increase for 1231 gain	115	115
Increased for deemed interest income	0	100
Stock basis before distribution	190	290
Less: non-dividend distribution	50	107
Stock basis before losses & deductions	140	183
Less: Ordinary Loss ($158, limited to basis)	(140)	(158)
Ending stock basis	0	25
Suspended loss	18	0

In both cases, the shareholder has to include in income $100 of deemed interest income from tax credit bond and $115 of IRC 1231 gain from the S corporation. And in both cases, the shareholder has $60 in pocket at the end of the year. But under Scenario C, the shareholder has a taxable dividend of $10; under Scenario D, however, the shareholder has a taxable dividend of $53. The $43 difference is reflected in the shareholder's $18 of suspended loss carryover in Scenario C and the shareholder's $25 ending stock basis in Scenario D.

Examples of the Concept (cont'd)

Adjustments to Stock Basis

Examples

Basis Adjustments for Certain Tax Credit Bonds - Example 6 (cont'd)

The shareholder's Form 1040 would include the following items:

		Scenario C (Type-1 Shareholder)	Scenario D (Type-2 Shareholder)
8a	Taxable interest	100	100
9a	Ordinary dividends	10	53
14	Other gains	115	115
17	Sch. E	(140)	(158)
22	Total income	85	110

The difference between the $85 of total income under Scenario C and $110 of total income under Scenario D is reflected in the ending stock basis of $25 in scenario D and $0 in Scenario C.

Under Scenario C, the shareholder can deduct only $140 of the corporation's losses for the year and has a suspended loss of $18. Under Scenario D, however, the shareholder can deduct the entire $158. Under Scenario C, therefore, the shareholder has total income of $85; under Scenario D, however, the shareholder has total income of $110. Scenario D imposes a higher tax and therefore a greater amount of the credit is used in the current year than under Scenario C. In the subsequent year, the shareholder begins with a basis of zero under Scenario C but a basis of $25 under Scenario D.

If there is a net negative adjustment in both scenarios, the results can still differ in the two scenarios.

Examples of the Concept (cont'd)

Adjustments to Stock Basis

Examples

Basis Adjustments for Certain Tax Credit Bonds - Example 7

Assume the same facts as in Example 6, but with an ordinary loss of ($258) thus both Scenario have net negative adjustments.

	Scenario C (Type-1)	Scenario D (Type-2)
Beginning AAA	50	50
Plus: IRC 1231 gain	115	115
Plus: Deemed interest income	0	100
AAA before losses and deduction	165	265
Less: Ordinary Loss (limited for type-1 & 2)	(115)	(215)
AAA before distributions	50	50
Distributions ($60/$160; limited to AAA)	50	50
AAA before remaining loss	0	0
Remaining loss	(43)	(43)
Ending AAA	(43)	(43)
Total distribution	60	160
Non-dividend distribution from AAA	50	50
Dividend distribution from AE&P (limited to E&P)	10	70
Total non-dividend distribution	50	90
Beginning AE&P	70	70
Dividend	10	70
Ending AE&P	60	0

Examples of the Concept (cont'd)

Adjustments to Stock Basis

Examples

Basis Adjustments for Certain Tax Credit Bonds - Example 7 (cont'd)

	Scenario C (Type-1)	Scenario D (Type-2)
Beginning stock basis	75	75
Increase for IRC 1231 gain	115	115
Increase for deemed interest income	0	100
Stock basis before distributions	190	290
Less: non-dividend distribution	(50)	(90)
Basis before losses & deductions	140	200
Less: Loss ($258, but limited to basis)	140	200
Ending stock basis	0	0
Suspended loss	118	58

In both scenarios, the shareholder has to include in income $100 of deemed interest income from the tax credit bond and $115 from the S corporation's IRC 1231 gain. And in both cases, the shareholder has $60 in pocket at the end of the year. But in Scenario C, the shareholder has a taxable dividend of $10; whereas in Scenario D, the shareholder has a taxable dividend of $70. To offset this, in Scenario C the shareholder has a $118 suspended loss whereas the shareholder in Scenario D only has a suspended loss of $58.

Examples of the Concept (cont'd)

Adjustments to Stock Basis

Examples

Basis Adjustments for Certain Tax Credit Bonds - Example 7 (cont'd)

In each scenario, the shareholder's Form1040 includes the following items:

		Scenario C (Type-1 Shareholder)	Scenario D (Type-2 Shareholder)
8a	Taxable interest	100	100
9a	Ordinary dividends	10	70
14	Other gains	115	115
17	Sch. E	(140)	(200)
22	Total income	85	85

Examples of the Concept (cont'd)

Adjustments to Stock Basis

Examples

IRC 179D and Stock Basis - Example 8

- A shareholder starts an S corporation with $100.
- The S corporation generates $1,000 of profit (cash) for the three years of its existence.
- The shareholder withdraws $850 of the cash.
- This leaves $150 of profit (cash) in the S corporation.
- This results in $250 cash in the S corporation ($100 initial investment + $150 profit) at liquidation.
- The shareholder's stock basis is $250 ($100 initial investment + $1,000 profit - $850 distribution).

When the S corporation liquidates, the shareholder will receive $250 in liquidation and his stock basis will be $250, so the shareholder has no IRC 331 gain or loss upon liquidation.

IRC 179D and Stock Basis - Example 9

Assume the same facts in Example 8, except that in year two, the S corporation is allocated a $40 IRC 179D deduction.
- The S corporation generates $1,000 of profit (cash) for the three years of its existence.
- The shareholder withdraws $850 of the cash.
- This leaves $150 of profit (cash) in the S corporation.
- This results in $250 cash in the S corporation ($100 initial investment + $150 profit) at liquidation.
- The shareholder's stock basis is $210 ($100 initial investment + $1,000 profit - $850 distribution - $40 179D deduction).

When the S corporation liquidates, the shareholder will receive $250 in liquidation and his stock basis will be $210, so the shareholder has a $40 IRC 331 gain upon liquidation.

Other than the time value of money (deduction in year two with gain on liquidation in year 3) and the character of the gain on liquidation is capital while the IRC 179D deduction is ordinary, the shareholder has not benefited from the allocation of the IRC 179D deduction from the governmental body because the IRC 179D deduction reduces the shareholder's basis.

Index of Referenced Resources

Adjustments to Stock Basis
IRC 50(c)
IRC 54
IRC 54A
IRC 54B
IRC 54C
IRC 54D
IRC 54E
IRC 54F
IRC 54AA
IRC 101
IRC 108
IRC 179D
IRC 264(a)(1)
IRC 311
IRC 1366(a)(1)

Index of Referenced Resources (cont'd)

Adjustments to Stock Basis
IRC 1367
IRC 1368
IRC 1397E(l)(2)
IRC 1400N
Treas. Reg. 1.45D-1(f)(2)
Treas. Reg. 1.199-5(c)
Rev. Rul. 2009-13 – Sale or Surrender of Life Insurance Contract
Barnes v. Comm'r - 712 F.3d 581 (D.C. Cir. 2013)
CCA 201421015 – IRC 311(a)
PLR 200409010 – General Rule for Taxable Year of Inclusion
AM 2010007- Legal Advice Issued by Associate Chief Counsel - IRC 179D
Pub. L. 110-343 Div. C, sec. 702 (2008)
Form 1040, Schedule A - *Itemized Deductions*
Form 1116 – *Foreign Tax Credit*
Form 1120S - *U.S. Income Tax Return for an S Corporation*
Form 1120S, Schedule K-1 - *Shareholder's Share of Income, Deductions, Credits, etc.*

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Index of Referenced Resources (cont'd)

Adjustments to Stock Basis
Audit Tool - Energy Efficient Commercial Building IRC 179D – Technical Specifications v. Shop Drawings
Audit Tool - Energy Efficient Commercial Building Deduction IRC 179D
Audit Tool - S Corporations Corporate Issues & Advanced Topics Issue Guide
Audit Tool - S Corporations Distributions Issue Guide
Audit Tool - S Corporation Operations Issue Guide
Audit Tool - S Corporations Transactions with Shareholders Issue Guide

Training and Additional Resources

Adjustments to Stock Basis	
Type of Resource	**Description(s)**
SABA Sessions	▪ *Overview of S Corp Stock Basis* - 2014 Centra
Issue Toolkits	▪ Audit Tool - S Corporation Shareholder Loss Limitation Issue Guide ▪ Audit Tool - S Corporation Stock & Debt Issue Guide ▪ Audit Tool - Stock & Debt Basis Worksheet Tools ▪ Snapshot - Determining a Shareholder's Initial Stock Basis ▪ Audit Tool - FAQs – Basis & Loss Limitations
Reference Materials	▪ *Practitioners Publishing Company (PPC) - 1120S Deskbook*

Glossary of Terms and Acronyms

Term/Acronym	Definition
AAA	Accumulated Adjustments Account
AE&P	Accumulated Earnings and Profits
AMT	Alternative Minimum Tax
CSV	Cash Surrender Value
DPAD	Domestic Production Activities Deduction
FMV	Fair Market Value
FTC	Foreign Tax Credit
PLR	Private Letter Ruling
QZAB	Qualified Zone Academy Bonds

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Index of Related Practice Units

Associated UIL(s)	Related Practice Unit	DCN
1367.01-00	*Initial Stock Basis*	SCO/C/53_4_1_1-01(2016)
1367.04-00	*Stock Basis Ordering Rules*	SCO/C/53_4_1_3-03(2016)
1367.02-00	*Valid Shareholder Debt Owed by S Corporation*	SCO/C/53_4_2_1-04(2016)
1367.00-00	*Adjustments to Debt Basis*	SCO/C/53_4_2_2-05(2016)