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	53.4.2	Debt Basis
Subsection	53.4.2.2	Adjustments to Debt Basis

Unit Name	Adjustments to Debt Basis	
Primary UIL Code	1367.00-00	Adjustment to Basis of Stock of, and Indebtedness Owing, Shareholders

Document Control Number (DCN)	SCO/C/53_4_2_2-05(2016)
Date of Last Update	01/18/18

Table of Contents

(View this PowerPoint in "Presentation View" to click on the links below)

General Overview

Adjustments to Debt Basis

As mentioned in the Initial Stock Basis Practice Unit, it is important that shareholders know 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.

It is also important that shareholders know the amount of their debt basis when:

- The S corporation allocates a loss or deduction item to the shareholder,
- The S corporation makes a repayment on a loan from the shareholder, or
- The shareholder disposes of stock.

Distinctions Between Stock and Debt Basis

Shareholders must track stock basis and debt basis separately; they may not be combined. The taxability of distributions is determined by stock basis ONLY, therefore distributions reduce stock basis, but do not reduce debt basis. Conversely, the taxability of loan repayments are determined by debt basis ONLY.

Detailed Explanation of the Concept

Adjustments to Debt Basis
Once an S corporation shareholder's stock basis is reduced to zero, the shareholder's debt basis is decreased by items of loss and deductions, non-deductible expenses and depletion, and is increased by the net increase.

Analysis	Resources
<u>Reductions to Debt Basis</u> Losses and deductions are first applied to the shareholder's stock basis and then to the shareholder's debt basis. In other words, when a shareholder's stock basis is reduced to zero, any excess losses and deductions are then allowed to the extent the shareholder has basis in loans to the corporation. Losses or deductions reduce debt basis in the same manner in which they reduce stock basis.	▪ IRC 1366 ▪ IRC 1367(b)(2)(A) ▪ See Examples of the Concept #1
<u>Reductions to Debt Basis and More than One Loan</u> If more than one loan is made by the shareholder to the corporation, any allocated loss is prorated between the loans. The proration is based on the ratio that each individual loan bears to the aggregate bases of all of the outstanding loans. Stated in a formula: $\frac{\text{Individual Loan Basis}}{\text{Total Loan Basis}}$ X Allocated Loss = Basis Reduction for Individual Loan	▪ Treas. Reg. 1.1367-2(b)(3) ▪ See Examples of the Concept #2

Detailed Explanation of the Concept (cont’d)

<table>
<tr><th colspan="2">Adjustments to Debt Basis</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td>
<u>Basis Restoration Ordering Rules</u>
As previously discussed, debt basis and stock basis are both reduced by losses and deductions. Additionally, stock and debt basis are increased, or restored, by the same income items. Therefore, it is critical to understand the order in which increases and decreases take place.
Stock basis is decreased first and then debt basis is decreased. However, when basis is increased, debt basis is restored first and then stock basis is increased.
<table>
<tr><th></th><th>Stock</th><th>Debt</th></tr>
<tr><td>Basis Decrease</td><td>1st</td><td>2nd</td></tr>
<tr><td>Basis Increase</td><td>2nd</td><td>1st</td></tr>
</table>
</td><td>

IRC 1367(b)(2)(B)
Treas. Reg. 1.1367-2(c)(1)
See Examples of the Concept #3

</td></tr>
<tr><td>
<u>Net Increase Rule</u>
The purpose of the net increase rule is to allow current year earnings to be distributed tax-free, or current year losses to be deductible, before debt basis is restored. Therefore, once debt basis has been reduced, it can ONLY be restored to the extent that the items that increase stock basis (income, tax-exempt income, excess depletion, etc.) exceed the items that decrease stock basis (losses, deductions, non-deductibles, non-dividend distributions, etc.), i.e. “net increase”. The net increase restores debt basis up to its current loan balance (face amount) before increasing stock basis.
</td><td>

Treas. Reg. 1.1367-2(c)(2)
See Examples of the Concept #4 & #5

</td></tr>
</table>

Detailed Explanation of the Concept (cont'd)

Adjustments to Debt Basis	
Analysis	**Resources**
Net Increase with More than One Loan When there is more than one loan, debt basis is restored on a pro-rata basis if the S corporation has not repaid any of the loans during the taxable year. The ratio is the percentage of each loan's basis reduction over the total basis reduction. Stated in a formula: $\frac{\text{Individual Loan Reduction}}{\text{Total Loan Reductions}} \times \text{Net Increase} = \text{Basis Restoration for Individual Loan}$	▪ Treas. Reg. 1.1367-2(c)(2) ▪ See Examples of the Concept #6

Examples of the Concept

Adjustments to Debt Basis

Examples

Example 1 – Reductions to Debt Basis

Bob has ($7,000) of losses in excess of stock basis. Bob also lent the S corporation $10,000 during the year. Based on the $10,000 loan from shareholder, Bob could claim the ($7,000) loss in excess of stock basis.

Note, even though the S corporation still owes Bob $10,000, the ($7,000) loss in excess of stock basis reduces the basis of Bob's debt to $3,000. The face amount of the debt is still $10,000 and should be reflected on the corporate balance sheet, but Bob's adjusted basis in the $10,000 loan is $3,000.

Adjusted Basis of $10,000 Debt Before Loss	10,000
Loss Allowed Against Debt Basis	(7,000)
Adjusted Basis of Debt at Year End	3,000

Example 2 – Reductions to Debt Basis and More than One Loan

S Corporation, a calendar year corporation, elected S status in Year 1, the first year of its existence. The only two shareholders are John and Marge. At incorporation:

- John purchased 100 shares for $15,000, and
- Marge purchased 50 shares for $7,500.

John also made loans to the corporation, evidenced by formal notes:

- $3,000 in Year 1, and
- $12,000 in Year 2.

Adjustments to Debt Basis

Examples

<u>Example 2 – Reductions to Debt Basis and More than One Loan (cont'd)</u>

The corporation has $6,000 of ordinary income on December 31, Year 1, and both shareholders reported their share on their individual tax returns. No distributions are made.

For Year 2, the corporation reports an ordinary loss of ($42,000) and makes no distributions.

John's adjusted basis in the loans to the corporation as of the end of Year 2 are computed as follows:

Stock Basis Beginning of Year 1	15,000
Allocable Share of Year 1 Ordinary Income: 2/3 of (6,000)	4,000
Stock Basis End of Year 1	19,000
Allocable Share of Year 2 Ordinary Loss: 2/3 of (42,000)	(28,000)
Balance to Reduce Basis of Indebtedness:	(9,000)

	Year 1 Loan	Year 2 Loan	Total
Original Loan	3,000	12,000	15,000
Reduction*	(1,800)	(7,200)	(9,000)
Basis End of Year 2	1,200	4,800	6,000

Year 1 Loan $\frac{3{,}000}{15{,}000}$ X (9,000) = (1,800)*

Year 2 Loan $\frac{12{,}000}{15{,}000}$ X (9,000) = (7,200)*

Examples of the Concept (cont'd)

Adjustments to Debt Basis

Examples

Example 3 – Basis Restoration Ordering Rules

Dottie, the sole shareholder of an S corporation, has the following adjusted basis at the end of the Year 1:

Stock basis	5,000	
Basis in loans	15,000	(Face Amount is $15,000)

During the next year, the S corporation incurs an operating loss of ($12,000). Dottie's adjusted basis at the end of Year 2 is:

	Stock	Debt
Beginning Basis	5,000	15,000
Operating Income: (12,000)	(5,000)	(7,000)
Ending Basis	0	8,000

During Year 3, the S corporation generates operating income of $9,000. Dottie's adjusted basis at the end of Year 3 is:

	Stock	Debt
Beginning Basis	0	8,000
Operating Income: 9,000	2,000	7,000
Ending Basis	2,000	15,000

Examples of the Concept (cont'd)

Adjustments to Debt Basis

Examples

Example 4 – Net Increase Rule

Assume the same facts as Example 3 where in Year 3 the S corporation generated operating income of $9,000. Add the fact there is a $3,000 non-dividend distribution to Dottie. Dottie's adjusted basis is computed as follows:

	Stock	Debt	
Beginning Basis	0	8,000	
Operating Income: 9,000	3,000	6,000	*
Less: Non-Dividend Distributions	(3,000)		
Ending Basis	0	14,000	

*Net Increase: $6,000 ($9,000 income – $3,000 distribution)

Example 5 – Net Increase Rule

Sole shareholder Bill lent $1 million to his S corporation. At the beginning of the year, Bill's adjusted basis in his debt is $600,000 based on ($400,000) in prior year losses.

Face Amount at Beginning of the Year	1,000,000
Prior Year Losses in Excess of Stock Basis	(400,000)
Debt Basis at the Beginning of the Year	600,000

During the year, the corporation earns $350,000 in ordinary income. Since this is Bill's only source of income, he withdraws $325,000 to pay his personal expenses and taxes owed on the $350,000 of income. (This example is for illustration of the net increase rule; we will not address that there may be an inadequate compensation issue for Bill.)

Ordinary Income	350,000
Less: Non-Dividend Distributions	(325,000)
Net Increase	25,000

Examples of the Concept (cont’d)

Adjustments to Debt Basis

Examples

Example 5 – Net Increase Rule (cont’d)

NOTE: FOR ILLUSTATION ONLY! Without the netting rule, all of the $350,000 of current year income would first restore the debt basis to $950,000 (600,000 + 350,000). Stock basis is still $0 and Bill would have a distribution of $325,000 in excess of stock basis, which is taxed as a capital gain (CG).

Hypothetical - Without Netting Rule	Stock Basis	Debt Basis
Beginning Balance	0	600,000
Ordinary Income		350,000
Ending Basis Before Distribution	0	950,000
Distribution in Excess of Stock Basis	325,000	CG

With the netting rule, $25,000 (the net increase) of the $350,000 in income restores debt basis, and $325,000 of the $350,000 income restores stock basis. Since income first increases stock basis before distributions, Bill now has stock with a $325,000 basis before distributions and therefore none of the $325,000 distribution is taxable. Bill’s ending stock basis is zero and his ending debt basis is $625,000 computed as follows:

With Netting Rule	Stock Basis	Debt Basis
Beginning Balance	0	600,000
Ordinary Income	325,000	25,000
Ending Basis Before Distribution	325,000	625,000
Distribution in Excess of Stock Basis	0	

NOTE: Example 5 could have a different answer if the S corporation was once a C corporation with earnings and profits.

Examples of the Concept (cont'd)

Adjustments to Debt Basis

Examples

Example 6 – Net Increase Rule and More than One Loan

As discussed in Example 2, John's ending Year 2 adjusted basis in his two loans to his S Corporation are as follows:

	Year 1 Loan	Year 2 Loan	Total
Original Loan	3,000	12,000	15,000
Year 2 Basis Reduction	(1,800)	(7,200)	(9,000)
Ending Debt Basis	1,200	4,800	6,000

In Year 3, the S corporation generates $6,000 of ordinary income. John's share of the ordinary income is $4,000. Assuming there are no loan repayments, John's adjusted basis in his loans to the corporation at the end of Year 3 are computed as follows:

	Year 1 Loan	Year 2 Loan	Total
Original Loan	3,000	12,000	15,000
Year 2 Reduction	(1,800)	(7,200)	(9,000)
Ending Basis Year 2	1,200	4,800	6,000
Year 3 Basis Increase *	800	3,200	4,000
Ending Debt Basis Year 3	2,000	8,000	10,000

Year 1 Loan $\frac{1,800}{9,000}$ x 4,000 = 800 *

Year 2 Loan $\frac{7,200}{9,000}$ x 4,000 = 3,200 *

Index of Referenced Resources

Adjustments to Debt Basis
IRC 1366
IRC 1367(b)(2)
Treas. Reg. 1.1367-2(b)(3)
Treas. Reg. 1.1367-2(c)

Training and Additional Resources

Adjustments to Debt Basis	
Type of Resource	**Description(s)**
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 ▪ Audit Tool - FAQs - Basis & Loss Limitations
Reference Materials – Treaties	▪ *Practitioners Publishing Company (PPC) - 1120S Deskbook*

Glossary of Terms and Acronyms

Term/Acronym	Definition
CG	Capital Gain

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)
1367.00-00	*Adjustments to Stock Basis*	SCO/C/53_4_1_2-02(2016)
1367.01-00	*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)