

# Form 7203 - S Corporation Shareholder and Debt Basis Limitations

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## A. S Corporation and Shareholder Basis

1. S corporations created by Congress in 1958
2. Income, losses, and distributions flow through from S corporation to shareholder
3. Losses flow through to a shareholder only to extent of basis in the shareholder's stock and debt
4. Distributions to a shareholder in excess of stock (not debt) basis yield deemed sale of stock (and resulting net capital gain)
5. It is the shareholder's (not S corporation's) responsibility to compute and track basis in the shareholder's S corporation stock and debt
6. Over time, S corporation shareholders deducted losses (and taking distributions) with little or no consciousness of basis limitations
7. In 2018, IRS introduced a basis worksheet to be completed by shareholder and attached to shareholder's tax return
  - a. But few shareholder really did so (or did it well)
  - b. IRS couldn't track it (so could not enforce rules)

## B. Six Loss Limitation Hurdles

1. Business interest expense (Form 8990)
2. Excess loss limitation (Form 461)
3. Basis (Form 7203 for S corporation shareholders)
4. At-risk basis (Form 6198)
5. Passive loss (Form 8582)
6. Net operating loss carryforward limitation

- C. Effective for 2022 filing season, IRS now requires S corporation shareholders to prepare and attach all-new Form 7203 to track basis
  - 1. The form was developed to replace the 3-part Worksheet for Figuring a Shareholder's Stock and Debt Basis and its related instructions formerly found in the Shareholder's Instructions.
  - 2. Tracks S Corp shareholder stock basis and debt basis
  - 3. Measures losses allowed, disallowed, and carryovers
  - 4. No similar form for partnerships
- D. Parts of Form 7203
  - 1. Part I of Form 7203 addresses adjustments to stock basis as provided under section 1367.
  - 2. Part II must be completed if the taxpayer has personally loaned money to the corporation.
  - 3. Part III computes the current year losses and deduction, carryovers from previous years, the amount allocated to stock basis, the amount allocated to debt basis, and any carryover amounts.
- E. Form 7203 is used to figure potential limitations of a taxpayer's share of the S corporation's deductions, credits, and other items that can be deducted on the return.
- F. Individual, trust, and estate shareholders must attach Form 7203 if they:
  - 1. Are claiming a deduction for their share of an aggregate loss from an S corporation (including an aggregate loss not allowed in previous years because of basis limitations),
  - 2. Received a non-dividend distribution from an S corporation,
  - 3. Disposed of stock in an S corporation (whether or not gain is recognized), or
  - 4. Received a loan repayment from an S corporation.
- G. S corporations do not prepare and attach Form 7203 to Form 1120-S.
  - 1. Not the responsibility of S corporation to track basis

- H. Shareholder basis determined from shareholder's Form 1120-S K-1.
- I. Separate Forms 7203
  - 1. Separate 7203 for each S corporation the shareholder owns stock
  - 2. Separate 7203 for each block of stock for each S corporation
  - 3. Separate 7203 for each spouse
- J. Losses, Deductions, and Distributions
  - 1. Stock and debt basis
    - a. Losses and deductions pass to shareholder to extent of both shareholder's stock basis and debt basis
  - 2. Stock basis
    - a. Non-dividend distributions are nontaxable to shareholder to extent of stock basis only
    - b. Debt basis not considered when determining taxability of a distribution
- K. S Corporation Stock Basis (for each block of stock)
  - Initial capital contribution (or initial stock purchase price)
  - + Additional capital contributions (or purchase price)
  - + Ordinary income
  - + Separately stated income items
  - + Tax exempt income
  - + Excess depletion
  - Non-dividend distributions
  - Ordinary loss
  - Separately stated loss items
  - Nondeductible expenses
  - Depletion for oil and gas
  - Foreign tax credit paid (or accrued)
  - Sale (or redemption) of part of stock
  - Debt basis restoration

- L. S Corporation Shareholder Debt Basis (for each loan)  
 Initial loan balance (of loan S Corp owes to shareholder)  
 + Additional loans by shareholder to S corporation  
 - Loan repayments by S corporation to shareholder  
 - Reductions of loan basis  
 + Restorations of loan basis
- M. Carryover losses are treated as separately stated income and deducted only after taking into account current year distributions.

Beginning Basis  
 + Income and Gains  
 Recomputed Basis  
 - Distributions  
 Recomputed Basis  
 - Deductions and Losses  
 Ending Basis

N. Open Account Debt

1. Loans made to the S corporation that are not evidenced by a written instrument are referred to as an open account debt and are not separately tracked.
2. If an open account debt has a year-end balance greater than \$25,000, it will be classified as a formal note at the beginning of the next tax year and must be separately tracked [Reg. 1.1367-2(a)(2)(ii); Form 7203 Instructions, Part II].

O. Repayment of Shareholder Debt

1. Any repayment by S corporation to shareholder of debt owed by S corporation to shareholder:
  - a. Nontaxable to extent of recovery of basis in debt
  - b. Taxable to extent repayment by S corporation exceeds shareholder's basis in debt
  - c. Example: Shallow Water, Inc. (an S corporation) repays in full to Becky her loan to S Corp. Face amount of note \$50,000. Note's debt basis \$40,000. Becky's income on repayment by S corporation of note \$10,000 [Reg. §1.1367-2(a)(2)(ii)].
2. Any open account debt (including debt referenced in Reg. §1.1367-2(a)(2)(ii)) will result in ordinary gain and should be reported on Form 4797, Sales of Business Property [IRS Instructions Form 7203, Part II, Sec. C, Line 34].

P. Restoration of Debt Basis Accomplished by Increase in Items of Stock Basis

1. If debt basis has been reduced, it can only be restored with a net increase [§1367(b)(2)(B)].
2. The net increase is amount by which items that increase stock basis per §1367(a)(1) (e.g., income, tax-exempt income, etc.) exceed items that decrease stock basis per §1367(a)(2) (e.g., losses, deductions, nondeductibles, nondividend distributions, etc.) [§1.1367-2(c)(1)].
3. Increase in debt basis reported on Form 7203, Part II, Line 23.
4. Debt basis is restored before stock basis increased.

Q. Order of Distributions

1. Accumulated Adjustments Account (AAA)
2. Earnings and Profits (E&P) (only if prior C corporation or merged C corporation)
  - a. May elect on 1120-S to distributed E&P first (before AAA)
  - b. File 1099-DIV
3. Return of capital (stock basis)
4. Capital gain on deemed sale of stock

R. Practice Considerations

1. Statute of limitations
  - a. IRS assessment of tax for any given year (3 years after later of actual filing date or due date [§6501]).
  - b. IRS may at any time challenge historically computed basis if it affects tax liability in an open year – Must prove basis at any time
2. It may be beneficial for shareholders to complete, retain, and file Form 7203 even for years it is not required to be filed, to ensure their bases are consistently maintained year after year [IRS 7203 Instructions (p. 2)]

3. When obtaining new client, do not take prior computed stock and debt shareholder basis as provided; recompute basis.
  - a. Many shareholders have no idea what their basis is.
    - 1) If the taxpayer cannot prove basis, then basis is zero.
    - 2) Burden of proof is on the taxpayer.
  - b. Compute basis as far back as possible.

#### S. Reconstructing Stock Basis

1. Original acquisition – Section 351 transaction or purchase
2. Subsequent stock acquired – Form 1120-S, Schedule K-1 shows beginning and end of year stock ownership percentages
3. Later capital contributions – difficult to reconstruct
  - a. K-1s do not show additional paid-in capital and capital contributions
  - b. Form 1120-S balance sheets may provide additional contributions
  - c. Shareholder financial records may provide information
4. Additional Inquiries
  - a. Subsequent payments on original purchase
  - b. Purchases of additional blocks of stock
  - c. Compensation for services
  - d. Inherited shares
  - e. Shares received by gift
5. Prior years' tax returns – K-1s provide details of operation; additions and subtractions to basis

#### T. Reconstructing Debt Basis

1. Form 1120-S, Schedule K-1, Item I reflects loans from shareholder at beginning and end of year
2. Shareholder financial records showing any loan activity between shareholder and S corporation.
3. Evidence of any promissory notes.
4. Open account debt reflected in books and records.

U. There are potential limitations on corporate losses that you can deduct on your return. These limitations and the order in which you must apply them are as follows: the basis limitations, the at-risk limitations (Form 6198), the passive activity loss limitations (Form 8582), and the excess business loss limitations (Form 461).

V. Forgiven PPP loan is tax-exempt income.

1. Increases your basis.
2. May Treat Amounts Excluded In Any One of Below
  - a. As eligible expenses are paid or incurred,
  - b. When an application for PPP loan forgiveness is filed, or
  - c. When PPP loan forgiveness is granted [Rev. Proc. 2021-48].

W. Reconstructing Basis Via Cohan

1. The U.S. Tax Court used the Cohan Rule to reconstruct basis of a nondeductible traditional IRS [Andrew G. Shank, TCM 2018-33]