Pass Through to Shareholders

- Time of Pass Through
  - Items pass through in the shareholders’ year that includes the end of the corporation’s taxable year
  - Where shareholder dies
  - Transfers other than on death do not affect the taxable year in which income and loss pass through to shareholders

- Amounts of Pass Through
  - All income, loss, deductions and credits pass through
  - The tax on built-in gains reduces the gains that pass through
Pass Through to Shareholders

**Amounts of Pass Through**

– The tax on excessive passive income reduces the passive investment income that passes through

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Pass Through to Shareholders

**Character of items that pass through**

– Character is determined at the corporation level

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Pass Through to Shareholders

**Allocations Among Shareholders**

– Each shareholder takes into account his pro rata share
– Pro rata share is determined by –
  • Dividing an item into equal portions for each day in the year
  • Dividing each day’s portion among the shares outstanding on that day
Pass Through to Shareholders

- **Allocations among shareholders**
  - Election to close books
    - General rule
    - Exception

- **Allocations Among Shareholders**
  - Election to close books under regulations

- **Reallocations by the Service**
  - Where a family member works for or provides capital without reasonable compensation –
  - IRS can reallocate the S corp. income
Limits on Deducting Losses

- **At-Risk Limitation**
  - Section 465 limits loss to the at-risk amount

- **Shareholder is at-risk for**
  - Basis of the stock, plus
  - Any amount loaned to the S corporation

- **Passive Activity Loss Limitation**
  - Deduction limited to passive activity income from other passive activities
Limits on Deducting Losses

- Passive Activity Loss Limitation –
  
- Losses from passive activities can not offset salaries and portfolio income

Limits on Deducting Losses

- Passive Activity Loss Limitations
  
  - Passive activity loss is the excess of all losses from passive activities over all income from passive activities
  
  - Passive activity includes any trade or business activity in which the taxpayer does not materially participate

General Basis Rules Apply

- All the basis rules of a C corp. Also apply to an S corp. –
  
  - Section 351 rules
  
  - Tax free reorganization rules
  
  - Calculation of original basis
Increase Basis for Income

- Items of income pass through to the shareholders
- Tax-exempt income

Restoration of Debt Basis

- Where basis of debt has been reduced due to losses –
- Future increases in basis increase debt basis first

Time of Basis Increase

- Stock basis changes are as of the close of the corporation’s taxable year
- Basis increases for stock occur before the distribution rules apply
Time of Basis Increase

- **General Rules for Debt Basis**
  - Debt basis changes are determined as of the close of the corporation’s taxable year
  - Two exceptions

**Time of Basis Increase**

- **Effect of election to close the books**
  - Stock basis is adjusted twice if there is an election to close the books
    - Once on the date the books are closed
    - Once at the end of the taxable year
  - Debt basis is adjusted in the same manner

**Allocation of Basis Increases Among Multiple Shares**

- **On a per-share, per-day basis**
- The basis of a share increases for the pass-through items that are attributable to that share
Losses Decrease Basis

- Losses and deductions that pass through decrease basis
  - Both separate and non-separate items of loss and deduction reduce basis
  - Basis is reduced even if deduction is suspended

Losses Decrease Basis

- Non capital, Nondeductible items
  - A nondeductible item that is not chargeable to capital account reduces basis

Losses Decrease Basis

- Allocation of Decrease Between Stock and Debt
  - Basis of stock is reduced first
  - Basis of debt is reduced only after basis of stock has been reduced to zero
  - Basis decrease occurs only for debt held by the shareholder at the close of the year
Losses Decrease Basis

Allocation of Basis Decrease Among Multiple Shares
- Increases and decreases are applied separately to each share
- Basis of a share decreases by the portion of the losses and deductions attributable to that share on a per-share, per-day basis

Allocation of Decrease Among Multiple Debts
- Basis reduction applies to each debt in proportion to that debt's percentage of the total basis for all the debts

Relationship to Worthless Stock and Debt Deductions
- The corporate loss passes through and reduces basis before a worthless stock loss is determined
- The same rule applies to determining a bad debt loss on debt owed to a S corporation shareholder
Basis Decrease for Tax-Free Distributions

- Tax-Free Distributions Reduce Stock Basis
  - Reduction cannot be below zero
  - If the distribution is property other than cash, the FMV of the property is the amount that reduces basis

Effect of Midyear Stock Transfers

- Sales
- Gifts

Basis as Limit on Deduction of Losses

- Deduction limited to total adjusted basis of the stock and shareholder debt
- Losses not deductible are suspended
- Stock basis is adjusted by the year's income before the limit is considered
Basis as Limit on Deduction of Losses

- The limit applies without any change in the basis of debt for the year's activity
- Distributions are taken into consideration before any reduction in basis due to losses
- Guarantee of corporate debt does not give the shareholder more basis
- Indefinite carryforward of a suspended loss

Application in Year of Stock Transfer

- Basis of stock transferred is determined before the transfer
  - Loss allocated to stockholder reduces basis before sale

Worthlessness of Stock and Debt

- Loss of the S corp. passes through and any remaining basis is deducted as-
  - Capital loss for the stock
  - Nonbusiness bad debt for the debt
Methods of Avoiding the Impact of Having No Basis

- Additional Cash Contribution or Stock Purchase
- Loan of Additional Cash
- Back to Back Loans
- Contribution of Property
- Purchase of Stock or Debt for Note
- Guarantee of Corporate Debt

Impact of Basis on Gain, Loss and Income

- When Does Basis Affect Gain of Loss?
  - Sale or exchange
  - Worthlessness
  - Some redemptions
  - Complete liquidations
  - Taxable boot in reorganizations
  - Corporation’s repayment of its debt

- When does basis not affect gain or loss?
  - Distributions out of Earnings and Profits where E & P exceeds the amount of the distribution
  - Redemptions treated as a dividend