

Form 7203 & Shareholder Basis

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Course Description

Form 7203, also known as “S Corporation Shareholder Stock and Debt Basis Limitations,” is used by S corporation shareholders to determine the potential limitations on their share of the S corporation’s deductions, credits, and other items that can be deducted on their individual tax returns. The form reports the shareholders outside basis as well as debt basis to apply any loss or at-risk limitations under I.R.C § 465 or I.R.C § 469 properly. This course will look at the mechanics of preparing Form 7203, when it is required to be attached to the Form 1040, Individual Income Tax Return, along with a discussion of strategies on how to reconstruct a shareholder’s basis when it has not been done in the past.

Objectives:

1. Introduce Form 7203
2. Learn how to complete Form 7203
3. Discuss strategies to reconstruct Shareholder Basis
4. Review loss limitations of §469
5. Review at-risk rules and limitations of § 465

Overview

The IRS has been moving toward requiring some type of individual Basis reporting of shareholders, members, partners of flow-through entities for the past several years. Out of several National Research Projects (IRS Campaign) conducted by the Large Business & International (LB&I) Division of the IRS, it was noted that more needed to be done to better track S Corporation Shareholders Basis to properly allow pass-through losses or subject to the limitations of I.R.C. §465 and §469. LB&I presented the following upon completion of its study: *“S corporation shareholders report income, losses and other items passed through from their corporation. The law limits losses and deduction to their basis in the corporation. LB&I has found that shareholders claim losses and deduction to which they are not entitled because they do not have sufficient stock or debt basis to absorb these items. LB&I has developed technical content for this campaign that will aid revenue agents as they examine the issue. The treatment streams for this campaign will be issue-based examinations, soft letters encouraging voluntary self-correction, conducting stakeholder outreach, and creating a new form for shareholders to assist in properly computing their basis.”* Beginning in 2018 the IRS changed Part II of Schedule E to add check boxes for basis reporting requirements as part of the research project.

Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II **Income or Loss From Partnerships and S Corporations**

Note: If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198**. See instructions.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered “Yes,” see instructions before completing this section **Yes** **No**

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
A			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
B			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
C			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
D			<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>

Beginning with tax year 2021 individual S Corporation Shareholders may be required to file Form 7203 as part of their Individual Income Tax Return Form 1040 if certain criteria are

met related to items reported on Schedule K-1. Form 7203, S Corporation Shareholder Stock and Debt Basis Limitations, replaces the Worksheet for Figuring a Shareholder's Stock and Debt Basis, which was available prior to tax year beginning 2021. While Form 7203 is required to be attached to the Individual Income Tax Return Form 1040 when certain criteria are met, even if the criterion are not met it is highly recommended that this form be completed to establish the individual's stock and debt basis or, at the very least, complete the Stock and Debt Basis Worksheet.

Form 7203 is required to be filed if a shareholders Schedule K-1 reports any of the following:

1. A deduction for their share of an aggregate loss from an S Corporation (including an aggregate loss not allowed from a prior year due to basis limitation), OR
2. Received a non-dividend distribution from an S Corporation, OR
3. Disposed of stock in an S Corporation (regardless of whether gain is recognized), OR
4. Received a loan repayment from an S Corporation.

Practitioner Note

A shareholder may receive a Dividend Distribution if the entity transacted business and was taxed as a C Corporation for a duration of time prior to electing Subchapter S Status. Additionally, there must have been positive Earnings & Profits at the time of the election for the distribution to qualify as a Dividend. Otherwise, all distributions are considered non-dividend distributions.

Example 1: Cindy Lou is a 50% shareholder of Whooville Candy Shop Inc., an S Corporation. She receives the following Schedule K-1, showing an Ordinary Business Loss of \$ 25,000, Interest income of \$ 2,500, Tax-exempt income of \$ 100,000 and Distribution of \$ 50,000.

Cindy Lou is required to file Form 7203 with her Individual Income Tax Return Form 1040 because the Schedule K-1 reports:

1. Ordinary Business Loss of \$ 25,000.
2. Distributions of \$ 50,000.

Observation

While the burden of proof lies with the taxpayer to calculate their basis correctly, it is quite unlikely that taxpayers will. Additionally, it is not the responsibility of the S Corporation to track the shareholder basis as this task lies solely outside the entity. Individual income tax return preparers should have procedures to make sure basis calculations are not missed.

At-Risk Limitations

I.R.C § 465, Deductions Limited to At-Risk indicates the following: “...engaged in an activity to which this section applies, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of subsection (b)) for such activity at the close of the taxable year.”

- *465(b)(1) In general. — For purposes of this section, a taxpayer shall be considered at risk for an activity with respect to amounts including—*
- *465(b)(1)(A) – the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and*
- *465(b)(1)(B) – amounts borrowed with respect to such activity (as determined under paragraph (2)).*

When determining amounts borrowed under §465(b)(1)(B), it is important to understand the shareholder is borrowing against their personal property and is personally liable for repayment of the debt. The shareholder may not include personal property already contributed to the S Corporation. The amount at risk will be the Net Fair Market Value on the date the property is pledged as collateral.

Items that are NOT At-Risk include Non-recourse Financing, Guarantees, Stop Loss Agreements or other similar arrangements. Publication 925 uses the example of a Commercial Feedlot to demonstrate what a Stop Loss Agreement is; this is when a farmer is reimbursed for

the loss on the sale of livestock. The amount At-Risk is only the amount the farmer put in not the amount reimbursed.

Passive Activity Limitations

I.R.C. §469 defines Passive Activity Limitations as:

- **469(c)(1) In general.** —The term “passive activity” means any activity
- **469(c)(1)(A)** – which involves the conduct of any trade or business (anticipating of starting a trade or business or for the purpose of research or experimental, and
- **469(c)(1)(B)** – in which the taxpayer does not materially participate.

The Passive Activity Limitations especially apply to rental real estate activities under Treas. Reg. 1.469-1T(e)(3) and 1.469-1(e)(3). Interconnected with Passive Activity is a concept of Material Participation. Material Participation is measured by the level of participation in that activity that a Shareholder has and is determined at the Shareholder level. The IRS as well as the courts have determined that it is important for individuals to maintain contemporaneous “daily records of participation” as proof of material participation. A Shareholder **must meet at least one** of the following criteria of Material Participation:

1. Participated more than 500 hours during the year. (Treas. Reg. §1.469-5(f)(1); Temp. Reg. 1.469-5T(f))
 - a. Example: Any work done for the activity while the shareholder owns an interest.
 - b. Example: Investor activity IS NOT participation (research, studying, reviewing financial statements).
2. Your participation for the tax year constituted substantially all the participation in the activity of all individuals.
3. Participated more than 100 hours during the year, and that participation wasn't less than other's participation.
4. Participation was significant for more than 500 hours and a minimum of 100 hours.

5. Materially participated in at least 5 of 10 tax years immediately preceding the current tax year.
6. The Activity was a personal service activity and there is material participation for any 3 years preceding the current tax year.
7. “Based upon the facts and circumstances, you participated in the activity on a regular, continuous, and substantial basis during the tax year”.

If the entity is engaged in Rental Real Estate, Shareholders may benefit from a special allowance where they may be able to deduct up to \$ 25,000 (\$ 12,500 MFS AND lived apart all year) of loss before having to carry over the remaining balance. The special allowance is not available to those filing MFS AND did not live apart at any time during the year. To qualify for this special allowance Shareholders must meet the Active Participation test rather than the more cumbersome Material Participation test. Under Active Participation the Shareholder must have:

1. At least 10% interest at any time during the year.
2. Must have made management decisions, including scheduling service providers in a significant way. Management decisions may also include approving new tenants, negotiating lease agreements and making decisions regarding capital expenditures;
AND
3. There are MAGI limitations for those taking advantage of this special allowance:
 - Less than \$ 100,000 (\$ 50,000 MFS) = up to \$ 25,000
 - Between \$ 100,000 - \$ 150,000 (\$50,000 - \$ 75,000 MFS) = up to 50%
 - More than \$ 150,000 (\$ 75,000 MFS) = No Special Allowance

Stock & Debt Basis Limitations

S Corporation Shareholders have a unique basis computation as it may have two components, Stock Basis, and Debt Basis. Once the Stock Basis is exhausted, they may be eligible to utilize Debt Basis as defined in Treas. Reg. 1.1366-2. Determining basis is done

annually and begins at the time the shareholder acquires their stock in the corporation, (“basis at the time of acquisition”).

Stock Basis is determined in the following order beginning with items that increase basis and ending with those that decrease basis:

1. Income items – ordinary, rental, investment, tax-exempt, separately stated and excess depletion
2. Distributions – ordinary, NOT dividends
3. Nondeductible Expenses – noncapital or depletion
4. Losses and other separately stated loss items

Debt Basis is defined in Treas. Reg. 1.1366-2 and states that “a debtor creditor relationship must exist”. A debtor creditor relationship exists only when the Shareholder has loaned their own money to the corporation, it DOES NOT exist when the Shareholder is the personal guarantor of debt loaned to the corporation. There is an exception when a Shareholder services the corporation’s debt out of their own funds, for example they pay a monthly loan payment directly from their own bank account. The principal amount of that payment will increase the Shareholders debt basis. When a Shareholder loans the corporation money, they receive Debt Basis and they may be required to have a written debt instrument such as, formal loan or promissory note document. Treas. Reg. 1.1367-2(a)(2)(ii) indicates that “any debt that exceeded \$ 25,000 at the end of the prior year is treated as a formal note...”. It further indicates that multiple loans may not be aggregated, and each must have their own debt instrument. The loan may qualify as revolving throughout any given year, however if at the end of the year the debt exceeds \$ 25,000 a formal debt instrument must be in place between the Shareholder and the Corporation. Revolving debt is when money is loaned to the company during the year, when cash-flow is strained for example. The amount repaid before the current year end may offset only the amount for that year, this is extremely short-term. Formal debt is that which repayment is expected to occur after the current year end, thus requiring the formal debt instrument if it exceeds \$ 25,000. If the revolving debt balance at year end exceeds \$ 25,000 the year end journal entry will be as follows and the N/P will become long-term debt rather than short-term:

	<u>Debit</u>	<u>Credit</u>
Current Year Loans from Shareholder	25,001.00	
N/P Loans from Shareholder		25,001.00

If there is gain recognized from loan repayment it is considered ordinary, reported on Form 4797 and basis is not increased; this will occur if there is not a formal debt instrument. Gain recognized on formal debt is considered capital, reported on Schedule D and basis is not increased. (Treas. Reg. 1.1367-2(a)(2)(ii))

Treas. Reg. 1.1367-(c)(2) indicates the following regarding multiple debts, “...*the net increase is applied first to restore the reduction of basis in any debt repaid in the tax year to the extent necessary to offset any gain that would otherwise be realized. Any remaining net increase is applied to each debt in proportion to it reduced basis.*”

Treas. Reg. 1.1367-2(b)(3) further indicates that loans to the corporation should be prorated based upon each loan’s basis to the aggregated basis of all loans.

Completing Form 7203

Form 7203, S Corporation Shareholder Stock and Debt Basis Limitations will be completed for each year an S Corporation shareholder receives a Schedule K-1 and meets the filing requirements. It is divided into three (3) parts, Part I Shareholder Stock Basis, Part II Shareholder Debt Basis and Part III Shareholder Allowable Loss and Deduction Items. Separate forms will be required if a shareholder receives multiple Schedule K-1’s from multiple entities. Additionally, if a shareholder sells different blocks of stock with different basis structures, separate forms will be required. (Tres. Reg. 1.1367-1(b)(2) and (c)(3))

Below is the completed Form 7203 for Example 1. Note the form is required to be filed with the shareholders individual tax return because the loss and distribution criteria are met. Even though there is an ordinary loss there is not a stock basis limitation because the tax-exempt income increases stock basis.

Form **7203**

(December 2021)
Department of the Treasury
Internal Revenue Service

S Corporation Shareholder Stock and Debt Basis Limitations

▶ Attach to your tax return.
▶ Go to www.irs.gov/Form7203 for instructions and the latest information.

OMB No. 1545-XXXX

Attachment Sequence No. **203**

Name(s) shown on return Cindy Lou	Identifying number
Name of S corporation Whoville Candy Shop	Employer identification number

Stock block (see instructions) ▶

Part I Shareholder Stock Basis			
1 Stock basis at the beginning of the corporation's tax year		1	5,000
2 Basis from any capital contributions made or additional stock acquired during the tax year		2	
3a Ordinary business income (enter losses in Part III)	3a		
b Net rental real estate income (enter losses in Part III)	3b		
c Other net rental income (enter losses in Part III)	3c		
d Interest income	3d		2,500
e Ordinary dividends	3e		
f Royalties	3f		
g Net capital gains (enter losses in Part III)	3g		
h Net section 1231 gain (enter losses in Part III)	3h		
i Other income (enter losses in Part III)	3i		
j Excess depletion adjustment	3j		
k Tax-exempt income	3k		100,000
l Recapture of business credits	3l		
m Other items that increase stock basis	3m		
4 Add lines 3a through 3m		4	102,500
5 Stock basis before distributions. Add lines 1, 2, and 4		5	107,500
6 Distributions (excluding dividend distributions)		6	50,000
Note: If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.			
7 Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15		7	57,500
8a Nondeductible expenses	8a		
b Depletion for oil and gas	8b		
c Business credits (sections 50(c)(1) and (5))	8c		
9 Add lines 8a through 8c		9	
10 Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15		10	57,500
11 Allowable loss and deduction items. Enter the amount from line 47, column (c)		11	25,000
12 Debt basis restoration (see net increase in instructions for line 23)		12	
13 Other items that decrease stock basis		13	
14 Add lines 11, 12, and 13		14	25,000
15 Stock basis at the end of the corporation's tax year. Subtract line 14 from line 10. If the result is zero or less, enter -0-		15	32,500

Part II Shareholder Debt Basis				
Section A—Amount of Debt (If more than three debts, see instructions.)				
Description	<input type="checkbox"/> Formal note <input type="checkbox"/> Open account debt	<input type="checkbox"/> Formal note <input type="checkbox"/> Open account debt	<input type="checkbox"/> Formal note <input type="checkbox"/> Open account debt	Total
16 Loan balance at the beginning of the corporation's tax year				
17 Additional loans (see instructions)				
18 Loan balance before repayment. Combine lines 16 and 17				
19 Principal portion of debt repayment (this line doesn't include interest)	()	()
20 Loan balance at the end of the corporation's tax year. Combine lines 18 and 19				

For Paperwork Reduction Act Notice, see separate instructions.

Form **7203** (12-2021)

Part II Shareholder Debt Basis (continued)**Section B—Adjustments to Debt Basis**

Description	Debt 1	Debt 2	Debt 3	Total
21 Debt basis at the beginning of the corporation's tax year				
22 Enter the amount, if any, from line 17				
23 Debt basis restoration (see instructions)				
24 Debt basis before repayment. Combine lines 21, 22, and 23				
25 Divide line 24 by line 18				
26 Nontaxable debt repayment. Multiply line 25 by line 19				
27 Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24				
28 Nondeductible expenses and oil and gas depletion deductions in excess of stock basis				
29 Debt basis before losses and deductions. Subtract line 28 from line 27. If the result is zero or less, enter -0-				
30 Allowable losses in excess of stock basis. Enter the amount from line 47, column (d)				
31 Debt basis at the end of the corporation's tax year. Subtract line 30 from line 29. If the result is zero or less, enter -0-				

Section C—Gain on Loan Repayment

32 Repayment. Enter the amount from line 19				
33 Nontaxable repayments. Enter the amount from line 26				
34 Reportable gain. Subtract line 33 from line 32				

Part III Shareholder Allowable Loss and Deduction Items

Description	(b) Carryover year losses and deductions	(b) Carryover amounts (column (e)) from the previous year	(c) Allowable loss from stock basis	(d) Allowable loss from debt basis	(e) Carryover amounts
35 Ordinary business loss	25,000		25,000		
36 Net rental real estate loss					
37 Other net rental loss					
38 Net capital loss					
39 Net section 1231 loss					
40 Other loss					
41 Section 179 deductions					
42 Charitable contributions					
43 Investment interest expense					
44 Section 50(e)(2) expenditures					
45 Other deductions					
46 Foreign taxes paid or accrued					
47 Total loss. Combine lines 35 through 46 for each column. Enter the total loss in column (c) on line 11 and enter the total loss in column (d) on line 30	25,000		25,000		

Form 7203 (12-2021)

Example 2: Cindy Lou receives another Schedule K-1 from Whoville Management & Consulting, showing an Ordinary loss of \$ 25,000, Net rental loss of \$ 10,500, Interest income of \$ 2,500, Royalties of \$ 62, §1231 gain of \$ 11,500, §179 of \$ 56,000 as well as a distribution of \$ 100,000. Here beginning Stock Basis is \$ 5,000.

1. Form 7203 is required because there is an Ordinary Loss and a Non-dividend distribution.
2. Cindy Lou will be limited by Stock Basis.
3. Cindy Lou does not have Debt Basis, so the entire loss is carried over to the next year.

**Schedule K-1
(Form 1120-S)**

2023

Department of the Treasury
Internal Revenue Service

For calendar year 2023, or tax year

beginning ending

Shareholder's Share of Income, Deductions, Credits, etc.
See separate instructions.

Part I Information About the Corporation		Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items	
A Corporation's employer identification number 99-0000000	1 Ordinary business income (loss) <25,000>	13 Credits	
B Corporation's name, address, city, state, and ZIP code Whooville Management & Consulting Inc 1000 Christmas Tree Lane Whooville	2 Net rental real estate income (loss) <10,500>		
	3 Other net rental income (loss)		
	4 Interest income 2,500		
C IRS Center where corporation filed return e-file	5a Ordinary dividends		
	5b Qualified dividends	14 Schedule K-3 is attached if checked <input type="checkbox"/>	
D Corporation's total number of shares Beginning of tax year 10000 End of tax year 10000	6 Royalties 62	15 Alternative minimum tax (AMT) items	
	7 Net short-term capital gain (loss)		
Part II Information About the Shareholder	8a Net long-term capital gain (loss)		
	8b Collectibles (28%) gain (loss)		
	8c Unrecaptured section 1250 gain		
E Shareholder's identifying number 200-11-2222	9 Net section 1231 gain (loss) 11,500	16 Items affecting shareholder basis	
F Shareholder's name, address, city, state, and ZIP code Cindy Lou Who 350 Christmas Tree Lane Whooville	10 Other income (loss)	D	50,000
	G Current year allocation percentage 50 %		17 Other information
H Shareholder's number of shares	11 Section 179 deduction 56,000		

S Corporation Shareholder Stock and Debt Basis Limitations

▶ Attach to your tax return.
▶ Go to www.irs.gov/Form7203 for instructions and the latest information.

Name(s) shown on return **Cindy Lou** Identifying number

Name of S corporation **Whoville Management & Consulting** Employer identification number

Stock block (see instructions) ▶

Part I Shareholder Stock Basis			
1	Stock basis at the beginning of the corporation's tax year	1	5000
2	Basis from any capital contributions made or additional stock acquired during the tax year	2	
3a	Ordinary business income (enter losses in Part III)	3a	
b	Net rental real estate income (enter losses in Part III)	3b	
c	Other net rental income (enter losses in Part III)	3c	
d	Interest income	3d	2500
e	Ordinary dividends	3e	
f	Royalties	3f	62
g	Net capital gains (enter losses in Part III)	3g	
h	Net section 1231 gain (enter losses in Part III)	3h	11500
i	Other income (enter losses in Part III)	3i	
j	Excess depletion adjustment	3j	
k	Tax-exempt income	3k	
l	Recapture of business credits	3l	
m	Other items that increase stock basis	3m	
4	Add lines 3a through 3m	4	14062
5	Stock basis before distributions. Add lines 1, 2, and 4	5	19062
6	Distributions (excluding dividend distributions) <i>Note: If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.</i>	6	100000
7	Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15	7	0
8a	Nondeductible expenses	8a	
b	Depletion for oil and gas	8b	
c	Business credits (sections 50(c)(1) and (5))	8c	
9	Add lines 8a through 8c	9	
10	Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15	10	
11	Allowable loss and deduction items. Enter the amount from line 47, column (c)	11	
12	Debt basis restoration (see net increase in instructions for line 23)	12	
13	Other items that decrease stock basis	13	
14	Add lines 11, 12, and 13	14	
15	Stock basis at the end of the corporation's tax year. Subtract line 14 from line 10. If the result is zero or less, enter -0-	15	0

Part II Shareholder Debt Basis
Section A—Amount of Debt (If more than three debts, see instructions.)

Description	Debt 1	Debt 2	Debt 3	Total
	<input type="checkbox"/> Formal note <input type="checkbox"/> Open account debt	<input type="checkbox"/> Formal note <input type="checkbox"/> Open account debt	<input type="checkbox"/> Formal note <input type="checkbox"/> Open account debt	
16 Loan balance at the beginning of the corporation's tax year				
17 Additional loans (see instructions)				
18 Loan balance before repayment. Combine lines 16 and 17				
19 Principal portion of debt repayment (this line doesn't include interest)	()	()	()	()
20 Loan balance at the end of the corporation's tax year. Combine lines 18 and 19				

For Paperwork Reduction Act Notice, see separate instructions.

Part II Shareholder Debt Basis (continued)

Section B—Adjustments to Debt Basis

Description	Debt 1	Debt 2	Debt 3	Total
21 Debt basis at the beginning of the corporation's tax year				
22 Enter the amount, if any, from line 17				
23 Debt basis restoration (see instructions)				
24 Debt basis before repayment. Combine lines 21, 22, and 23				
25 Divide line 24 by line 18				
26 Nontaxable debt repayment. Multiply line 25 by line 19				
27 Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24				
28 Nondeductible expenses and oil and gas depletion deductions in excess of stock basis				
29 Debt basis before losses and deductions. Subtract line 28 from line 27. If the result is zero or less, enter -0-				
30 Allowable losses in excess of stock basis. Enter the amount from line 47, column (d)				
31 Debt basis at the end of the corporation's tax year. Subtract line 30 from line 29. If the result is zero or less, enter -0-				

Section C—Gain on Loan Repayment

32 Repayment. Enter the amount from line 19			
33 Nontaxable repayments. Enter the amount from line 26			
34 Reportable gain. Subtract line 33 from line 32			

Part III Shareholder Allowable Loss and Deduction Items

Description	(b) Carryover year losses and deductions	(b) Carryover amounts (column (e)) from the previous year	(c) Allowable loss from stock basis	(d) Allowable loss from debt basis	(e) Carryover amounts
35 Ordinary business loss	25000				25000
36 Net rental real estate loss	10500				10500
37 Other net rental loss					
38 Net capital loss					
39 Net section 1231 loss					
40 Other loss					
41 Section 179 deductions	56000				56000
42 Charitable contributions					
43 Investment interest expense					
44 Section 59(e)(2) expenditures					
45 Other deductions					
46 Foreign taxes paid or accrued					
47 Total loss. Combine lines 35 through 46 for each column. Enter the total loss in column (c) on line 11 and enter the total loss in column (d) on line 30	91500				91500

Example 3: The facts are the same as in example 2 except Cindy Lou loaned Whoville Management & Consulting \$ 75,000 with a formal debt instrument.

Form 7203 <small>(December 2021) Department of the Treasury Internal Revenue Service</small>	S Corporation Shareholder Stock and Debt Basis Limitations Attach to your tax return. Go to www.irs.gov/Form7203 for instructions and the latest information.	OMB No. 1545-XXXX Attachment Sequence No. 203
Name(s) shown on return Cindy Lou		Identifying number
Name of S corporation Whoville Management & Consulting		Employer identification number

Stock block (see instructions) ▶			
Part I Shareholder Stock Basis			
1	Stock basis at the beginning of the corporation's tax year		5000
2	Basis from any capital contributions made or additional stock acquired during the tax year	2	
3a	Ordinary business income (enter losses in Part III)	3a	
b	Net rental real estate income (enter losses in Part III)	3b	
c	Other net rental income (enter losses in Part III)	3c	
d	Interest income	3d	2500
e	Ordinary dividends	3e	
f	Royalties	3f	62
g	Net capital gains (enter losses in Part III)	3g	
h	Net section 1231 gain (enter losses in Part III)	3h	11500
i	Other income (enter losses in Part III)	3i	
j	Excess depletion adjustment	3j	
k	Tax-exempt income	3k	
l	Recapture of business credits	3l	
m	Other items that increase stock basis	3m	
4	Add lines 3a through 3m	4	14062
5	Stock basis before distributions. Add lines 1, 2, and 4	5	19062
6	Distributions (excluding dividend distributions)	6	100000
<small>Note: If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.</small>			
7	Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15	7	0
8a	Nondeductible expenses	8a	
b	Depletion for oil and gas	8b	
c	Business credits (sections 50(c)(1) and (5))	8c	
9	Add lines 8a through 8c	9	
10	Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15	10	
11	Allowable loss and deduction items. Enter the amount from line 47, column (c)	11	
12	Debt basis restoration (see net increase in instructions for line 23)	12	
13	Other items that decrease stock basis	13	
14	Add lines 11, 12, and 13	14	
15	Stock basis at the end of the corporation's tax year. Subtract line 14 from line 10. If the result is zero or less, enter -0-	15	0

Part II Shareholder Debt Basis				
Section A—Amount of Debt (if more than three debts, see instructions.)				
Description	<input checked="" type="checkbox"/> Debt 1	<input type="checkbox"/> Debt 2	<input type="checkbox"/> Debt 3	Total
	<input type="checkbox"/> Formal note	<input type="checkbox"/> Formal note	<input type="checkbox"/> Formal note	
	<input type="checkbox"/> Open account debt	<input type="checkbox"/> Open account debt	<input type="checkbox"/> Open account debt	
16 Loan balance at the beginning of the corporation's tax year				
17 Additional loans (see instructions)	75000			
18 Loan balance before repayment. Combine lines 16 and 17	75000			
19 Principal portion of debt repayment (this line doesn't include interest)	()	()	()	()
20 Loan balance at the end of the corporation's tax year. Combine lines 18 and 19	75000			

For Paperwork Reduction Act Notice, see separate instructions. Form 7203 (12-2021)

Part II Shareholder Debt Basis (continued)

Section B—Adjustments to Debt Basis				
Description	(a) Debt 1	(b) Debt 2	(c) Debt 3	(d) Total
21 Debt basis at the beginning of the corporation's tax year				
22 Enter the amount, if any, from line 17	75,000			75,000
23 Debt basis restoration (see instructions)				
24 Debt basis before repayment. Add lines 21, 22, and 23	75,000			75,000
25 Divide line 24 by line 18	1.0000			
26 Nontaxable debt repayment. Multiply line 25 by line 19				
27 Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24	75,000			75,000
28 Nondeductible expenses and oil and gas depletion deductions in excess of stock basis				
29 Debt basis before losses and deductions. Subtract line 28 from line 27. If the result is zero or less, enter -0-	75,000			75,000
30 Allowable losses in excess of stock basis. Enter the amount from line 47, column (d)	75,000			75,000
31 Debt basis at the end of the corporation's tax year. Subtract line 30 from line 29. If the result is zero or less, enter -0-	0			

Section C—Gain on Loan Repayment				
32 Repayment. Enter the amount from line 19				
33 Nontaxable repayments. Enter the amount from line 26				
34 Reportable gain. Subtract line 33 from line 32	0			

Part III Shareholder Allowable Loss and Deduction Items					
Description	(a) Current year losses and deductions	(b) Carryover amounts (column (e)) from the previous year	(c) Allowable loss from stock basis	(d) Allowable loss from debt basis	(e) Carryover amounts
35 Ordinary business loss	25,000			20,490	4,510
36 Net rental real estate loss	10,500			8,610	1,890
37 Other net rental loss					
38 Net capital loss					
39 Net section 1231 loss					
40 Other loss					
41 Section 179 deductions	56,000			45,900	10,100
42 Charitable contributions					
43 Investment interest expense					
44 Section 59(e)(2) expenditures					
45 Other deductions					
46 Foreign taxes paid or accrued					
47 Total loss. Add lines 35 through 46 for each column. Enter the total loss in column (c) on line 11 and enter the total loss in column (d) on line 30	91,500			75,000	16,500

Prior to Form 7203 a Stock & Debt basis worksheet would have been used, however the IRS data mining tools cannot properly “match” information reported on worksheets. LB & I validated that in their study, hence the existence of Form 7203. Below is what the worksheet would look like if there was not Form 7203.

Name	Taxpayer Identification Number
	***-**-3333

Name of Entity Whoville Management & Consulting	EIN **-***0000
Passive Activity Type Not Passive	K1 Unit 1

Shareholder Stock Basis

1. Beginning of year stock basis. Per IRC 1367(a)(2) do not enter an amount below zero	1.	5,000
Increases to stock basis		
2. Capital contributions made or additional stock acquired	2.	
3. Ordinary business income	3.	
4. Net rental real estate income	4.	
5. Other net rental income	5.	
6. Interest, dividends and royalties	6.	2,562
7. Net capital gains	7.	
8. Net section 1231 gain and ordinary business gain	8.	11,500
9. Tax-exempt interest, other tax-exempt income and recapture credits	9.	
10. Other income	10.	
11. Excess of deductions for depletion over basis of property (other than oil and gas)	11.	
12. Other increases to stock basis	12.	
13. Total increases to stock basis. Combine lines 2 through 12	13.	14,062
14. Stock basis before distributions and items of loss or deductions. Add line 1 and line 13 and enter the result here	14.	19,062
Decreases to stock basis		
15. Distributions allowed Total Distributions 100,000	15.	19,062
16. Stock basis after distributions and before items of loss or deductions. Subtract line 15 from line 14. If zero or less, enter - 0 -	16.	0
17. Losses and deductions applied against stock basis. (See Shareholder Basis Worksheet Page 2)	17.	
18. Other decreases to stock basis	18.	
19. Amount used to restore loan basis	19.	
20. Total decreases (other than distributions) to stock basis. Combine lines 17 through 19	20.	0
21. Stock basis at the end of year. (Subtract line 20 from line 16). Per IRC 1367(a)(2) do not enter an amount below zero	21.	0

Shareholder Debt Basis

22. Debt basis at the beginning of corporation's tax year	22.	50,000
23. Additional loans	23.	75,000
24. Debt basis restoration	24.	
25. Nontaxable debt repayment	25.	5,000
26. Debt basis before losses and deductions. Combine lines 22 through 25	26.	120,000
27. Losses and deductions applied against debt basis. (See Shareholder Basis Worksheet Page 3)	27.	91,500
28. Debt basis at the end of year (Subtract line 28 from line 27).	28.	28,499
29. Stock and debt basis at the end of the year (Add lines 21 and line 28)	29.	28,499

Gain Recognized on Excess Distributions

30. Property distributions reported in Box 16, Code D, Schedule K-1 (1120S)	30.	100,000
31. Stock basis before distributions and loss items (line 14) less gain from the entire disposition of stock reported on line 18.	31.	19,062
32. Total gain recognized on excess distributions. (Subtract line 31 from line 30)	32.	80,938
<ul style="list-style-type: none"> ● Sch D/8949, short-term capital gain _____ ● Sch D/8949, long-term capital gain <u>80,938</u> 		

Name _____ Id No. *****-**-3333**
 Entity Name **Whoville Management & Consulting** EIN ****-***0000** Passive Activity Type **Not Passive** K1 Unit **1**

Basis reduced by nondeductible items before loss and deduction items

Shareholder Debt Basis										
Form 7203 Line #	Description	Debt 1 2021 Loa		Debt 2 2023 Loa		Debt 3	Debt 4	Debt 5	Debt 6	Total
		<input checked="" type="checkbox"/> Formal note <input type="checkbox"/> Open account		<input checked="" type="checkbox"/> Formal note <input type="checkbox"/> Open account		<input type="checkbox"/> Formal note <input type="checkbox"/> Open account	<input type="checkbox"/> Formal note <input type="checkbox"/> Open account	<input type="checkbox"/> Formal note <input type="checkbox"/> Open account	<input type="checkbox"/> Formal note <input type="checkbox"/> Open account	
16	Loan balance at the beginning of the corporation's tax year		50,000							50,000
17	Additional loans				75,000					75,000
18	Loan balance before repayment. Add lines 16 and 17		50,000		75,000					125,000
19	Principal portion of debt repayment (this line doesn't include interest)		5,000							5,000
20	Loan balance at the end of the corporation's tax year. Subtract lines 19 from line 18		45,000		75,000					120,000
21	Debt basis at the beginning of the corporation's tax year		50,000							50,000
22	Enter the amount, if any, from line 17				75,000					75,000
23	Debt basis restoration (see instructions)									
24	Debt basis before repayment. Add lines 21, 22, and 23		50,000		75,000					125,000
25	Divide line 24 by line 18		1.0000		1.0000					
26	Nontaxable debt repayment. Multiply line 25 by line 19		5,000							5,000
27	Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24		45,000		75,000					120,000
28	Nondeductible expenses and oil and gas depletion deductions in excess of stock basis									
29	Debt basis before losses and deductions. Subtract line 28 from line 27. If the result is zero or less, enter -0-		45,000		75,000					120,000
30	Allowable losses in excess of stock basis. Enter the amount from line 47, column (d)		34,313		57,188					91,500
31	Debt basis at the end of the corporation's tax year. Subtract line 30 from line 29. If the result is zero or less, enter -0-		10,687		17,812					28,499
Gain on Loan Repayment										
32	Repayment. Enter the amount from line 19		5,000							5,000
33	Nontaxable repayments. Enter the amount from line 26		5,000							5,000
34	Reportable gain. Subtract line 33 from line 32									

Form 1040	Shareholder's Basis Worksheet Page 3	2023
Name _____		Id No. ***-**-3333
Entity Name Whoville Management & Consulting		EIN **-***0000 Passive Activity Type Not Passive
Basis reduced by nondeductible items before loss and deduction items		K1 Unit 1

Loss Allocated to Shareholder Stock and Debt Basis										
	Suspended Losses	Current Year Loss	Total Loss	Percent	Allowed Stock Loss	Disallowed Stock Loss	Percent	Allowed Loan Loss	Disallowed Loss Carryforward	Total Allowed Loss
Nondeductible noncapital exp & oil/gas depletion deduction:							1.0000			
Losses and deductions:										
Ordinary business loss		25,000	25,000			25,000	0.2732	25,000		25,000
Net rental real estate loss		10,500	10,500			10,500	0.1148	10,500		10,500
Other net rental loss										
Short-term capital loss										
Long-term capital loss										
28% capital loss										
Section 1231 loss										
4797 - Ordinary loss										
Other portfolio loss										
1256 contracts and straddles										
Other losses - Schedule E										
Other losses - 1040 Sch 1										
Section 179 expense		56,000	56,000			56,000	0.6120	56,000		56,000
Cash contributions										
Cash contributions (30%)										
Noncash contributions (50%)										
Noncash contributions (30%)										
Cap gain prop 50% org (30%)										
Cap gain prop (20%)										
Portfolio deductions (other)										
Investment interest expense										
Depletion										
Deductions-royalty income										
Section 59(e)(2) expenditures										
Preproductive period exp.										
Reforestation expense ded.										
Other deductions										
Foreign taxes										
Total losses and deductions		91,500	91,500			91,500	1.0000	91,500		91,500
Total nonded and deductible items		91,500	91,500			91,500		91,500		91,500

Observation

Cindy Lou's reportable distributions in excess of basis is \$ 80,938 (\$ 100,000 – 19,062 of stock basis). When computing excess distributions only stock basis is factored. Unfortunately, excess distributions do not restore basis. This excess distribution is reported on form 8949 which flows through to Part II of Schedule D, both are shown below.

Part II Long-Term Capital Gains and Losses — Generally Assets Held More Than One Year (see instructions)				
See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8343, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b				
8b Totals for all transactions reported on Form(s) 8949 with Box D checked				
9 Totals for all transactions reported on Form(s) 8949 with Box E checked				
10 Totals for all transactions reported on Form(s) 8949 with Box F checked	80,938	0	0	80,938
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824			11	11,500
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1			12	
13 Capital gain distributions. See the instructions			13	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions			14	
15 Net long-term capital gain or (loss) . Combine lines 8a through 14 in column (h). Then go to Part III on the back			15	92,438

For Paperwork Reduction Act Notice, see your tax return instructions. **Schedule D (Form 1040) 2021**

DAA

Example 4: The facts are the same as Example 2 & 3 except Cindy Lou has a beginning loan balance of \$ 50,000 for another formal loan to the corporation. She also received a \$ 5,000 loan repayment during the year.

Practitioner Note

Stock basis is unaffected as is the gain-in-excess of distributions. The ability to utilize the debt basis, even with the loan repayment is advantageous to the taxpayer. Additionally, notice the loan repayment is applied to Debt 1, this is different than how the loan repayments may be handled within the entity. Within the S Corporation loan repayments are prorated amongst all the loans based upon the aggregated basis of all loans. (Treas. Reg. § 1367-2(b)(3))

**S Corporation Shareholder Stock and
 Debt Basis Limitations**
 Attach to your tax return.
 Go to www.irs.gov/Form7203 for instructions and the latest information.

Name of shareholder: _____

Identifying number
 ***-**-3333

A Name of S corporation: **Whoville Management & Consulting**

B Employer identification number: ****-**0000**

c Stock block (see instructions): _____

d Check applicable box(es) to indicate how stock was acquired:
 (1) Original shareholder (2) Purchased (3) Inherited (4) Gifted (5) Other: _____

e Check if you have a Regulations section 1.1367-1(g) election in effect during the tax year for this S corporation:

Part I Shareholder Stock Basis

1	Stock basis at the beginning of the corporation's tax year	1	5,000
2	Basis from any capital contributions made or additional stock acquired during the tax year	2	
3a	Ordinary business income (enter losses in Part III)	3a	
3b	Net rental real estate income (enter losses in Part III)	3b	
3c	Other net rental income (enter losses in Part III)	3c	
3d	Interest income	3d	2,500
3e	Ordinary dividends	3e	
3f	Royalties	3f	62
3g	Net capital gains (enter losses in Part III)	3g	
3h	Net section 1231 gain (enter losses in Part III)	3h	11,500
3i	Other income (enter losses in Part III)	3i	
3j	Excess depletion adjustment	3j	
3k	Tax-exempt income	3k	
3l	Recapture of business credits	3l	
3m	Other items that increase stock basis	3m	
4	Add lines 3a through 3m	4	14,062
5	Stock basis before distributions. Add lines 1, 2, and 4	5	19,062
6	Distributions (excluding dividend distributions) Note: If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.	6	100,000
7	Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15	7	0
8a	Nondeductible expenses	8a	
8b	Depletion for oil and gas	8b	
8c	Business credits (sections 50(c)(1) and (5))	8c	
9	Add lines 8a through 8c	9	
10	Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15	10	
11	Allowable loss and deduction items. Enter the amount from line 47, column (c)	11	
12	Debt basis restoration (see net increase in instructions for line 23)	12	
13	Other items that decrease stock basis	13	
14	Add lines 11, 12, and 13	14	
15	Stock basis at the end of the corporation's tax year. Subtract line 14 from line 10. If the result is zero or less, enter -0-	15	0

Part II Shareholder Debt Basis

Section A—Amount of Debt (If more than three debts, see instructions.)

Description	(a) Debt 1	(b) Debt 2	(c) Debt 3	(d) Total
	<input checked="" type="checkbox"/> Formal note <input type="checkbox"/> Open account	<input checked="" type="checkbox"/> Formal note <input type="checkbox"/> Open account	<input type="checkbox"/> Formal note <input type="checkbox"/> Open account	
16 Loan balance at the beginning of the corporation's tax year	50,000			50,000
17 Additional loans (see instructions)		75,000		75,000
18 Loan balance before repayment. Add lines 16 and 17	50,000	75,000		125,000
19 Principal portion of debt repayment (this line doesn't include interest)	5,000			5,000
20 Loan balance at the end of the corporation's tax year. Subtract lines 19 from line 18	45,000	75,000		120,000

Part II Shareholder Debt Basis (continued)

Section B—Adjustments to Debt Basis				
Description	(a) Debt 1	(b) Debt 2	(c) Debt 3	(d) Total
21 Debt basis at the beginning of the corporation's tax year	50,000			50,000
22 Enter the amount, if any, from line 17		75,000		75,000
23 Debt basis restoration (see instructions)				
24 Debt basis before repayment. Add lines 21, 22, and 23	50,000	75,000		125,000
25 Divide line 24 by line 18	1.0000	1.0000		
26 Nontaxable debt repayment. Multiply line 25 by line 19	5,000			5,000
27 Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24	45,000	75,000		120,000
28 Nondeductible expenses and oil and gas depletion deductions in excess of stock basis				
29 Debt basis before losses and deductions. Subtract line 28 from line 27. If the result is zero or less, enter -0-	45,000	75,000		120,000
30 Allowable losses in excess of stock basis. Enter the amount from line 47, column (d)	34,313	57,188		91,501
31 Debt basis at the end of the corporation's tax year. Subtract line 30 from line 29. If the result is zero or less, enter -0-	10,687	17,812		28,499

Section C—Gain on Loan Repayment				
32 Repayment. Enter the amount from line 19	5,000			5,000
33 Nontaxable repayments. Enter the amount from line 28	5,000			5,000
34 Reportable gain. Subtract line 33 from line 32	0	0		

Part III Shareholder Allowable Loss and Deduction Items

Description	(a) Current year losses and deductions	(b) Carryover amounts (column (e)) from the previous year	(c) Allowable loss from stock basis	(d) Allowable loss from debt basis	(e) Carryover amounts
35 Ordinary business loss	25,000			25,000	
36 Net rental real estate loss	10,500			10,500	
37 Other net rental loss					
38 Net capital loss					
39 Net section 1231 loss					
40 Other loss					
41 Section 179 deductions	56,000			56,000	
42 Charitable contributions					
43 Investment interest expense					
44 Section 59(e)(2) expenditures					
45 Other deductions					
46 Foreign taxes paid or accrued					
47 Total loss. Add lines 35 through 46 for each column. Enter the total loss in column (c) on line 11 and enter the total loss in column (d) on line 30	91,500			91,500	

Observation

The use of debt basis is merely to determine allowable losses of the taxpayer, it does not reduce the debt owed to the taxpayer by the corporation, therefore once stock basis is restored to a positive amount, debt basis must also be restored.

S Corporation Shareholder Stock and Debt Basis Limitations

OMB No. 1545-2302

Attach to your tax return.
Go to www.irs.gov/Form7203 for instructions and the latest information.

Attachment Sequence No. **203**

Name of shareholder Cindy Lou		Identifying number
A Name of S corporation Whoville Management & Consulting	B Employer identification number	
C Stock block (see instructions):		
D Check applicable box(es) to indicate how stock was acquired: (1) <input checked="" type="checkbox"/> Original shareholder (2) <input type="checkbox"/> Purchased (3) <input type="checkbox"/> Inherited (4) <input type="checkbox"/> Gift (5) <input type="checkbox"/> Other:		
E Check if you have a Regulations section 1.1367-1(g) election in effect during the tax year for this S corporation <input type="checkbox"/>		

Part I Shareholder Stock Basis

1 Stock basis at the beginning of the corporation's tax year	1	0.00
2 Basis from any capital contributions made or additional stock acquired during the tax year	2	
3a Ordinary business income (enter losses in Part III)	3a	150,000
b Net rental real estate income (enter losses in Part III)	3b	
c Other net rental income (enter losses in Part III)	3c	
d Interest income	3d	2,500
e Ordinary dividends	3e	
f Royalties	3f	62
g Net capital gains (enter losses in Part III)	3g	
h Net section 1231 gain (enter losses in Part III)	3h	11,500
i Other income (enter losses in Part III)	3i	
j Excess depletion adjustment	3j	
k Tax-exempt income	3k	
l Recapture of business credits	3l	
m Other items that increase stock basis	3m	
4 Add lines 3a through 3m	4	164,062
5 Stock basis before distributions. Add lines 1, 2, and 4	5	164,062
6 Distributions (excluding dividend distributions)	6	50,000
Note: If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.		
7 Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15	7	114,062
8a Nondeductible expenses	8a	
b Depletion for oil and gas	8b	
c Business credits (sections 50(c)(1) and (5))	8c	
9 Add lines 8a through 8c	9	
10 Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15	10	114,062
11 Allowable loss and deduction items. Enter the amount from line 47, column (c)	11	
12 Debt basis restoration (see net increase in instructions for line 23)	12	91,501
13 Other items that decrease stock basis	13	
14 Add lines 11, 12, and 13	14	91,501
15 Stock basis at the end of the corporation's tax year. Subtract line 14 from line 10. If the result is zero or less, enter -0-	15	22,561

Part II Shareholder Debt Basis

Section A—Amount of Debt (If more than three debts, see instructions.)

Description	(a) Debt 1	(b) Debt 2	(c) Debt 3	(d) Total
	<input checked="" type="checkbox"/> Formal note <input type="checkbox"/> Open account	<input checked="" type="checkbox"/> Formal note <input type="checkbox"/> Open account	<input type="checkbox"/> Formal note <input type="checkbox"/> Open account	
16 Loan balance at the beginning of the corporation's tax year	45,000	75,000		120,000
17 Additional loans (see instructions)				
18 Loan balance before repayment. Add lines 16 and 17	45,000	75,000		120,000
19 Principal portion of debt repayment (this line doesn't include interest)				
20 Loan balance at the end of the corporation's tax year. Subtract line 19 from line 18	45,000	75,000		120,000

Part II Shareholder Debt Basis *(continued)*

Section B—Adjustments to Debt Basis

Description	(a) Debt 1	(b) Debt 2	(c) Debt 3	(d) Total
21 Debt basis at the beginning of the corporation's tax year	10,687	17,812		28,499
22 Enter the amount, if any, from line 17				
23 Debt basis restoration (see instructions)	34,313	57,188		91,501
24 Debt basis before repayment. Add lines 21, 22, and 23	45,000	75,000		120,000
25 Divide line 24 by line 18	1	1		
26 Nontaxable debt repayment. Multiply line 25 by line 19				
27 Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24	45,000	75,000		120,000
28 Nondeductible expenses and oil and gas depletion deductions in excess of stock basis				
29 Debt basis before losses and deductions. Subtract line 28 from line 27. If the result is zero or less, enter -0-	45,000	75,000		120,000
30 Allowable losses in excess of stock basis. Enter the amount from line 47, column (d)				
31 Debt basis at the end of the corporation's tax year. Subtract line 30 from line 29. If the result is zero or less, enter -0-	45,000	75,000		120,000

Section C—Gain on Loan Repayment

32 Repayment. Enter the amount from line 19				
33 Nontaxable repayments. Enter the amount from line 26				
34 Reportable gain. Subtract line 33 from line 32				

Part III Shareholder Allowable Loss and Deduction Items

Description	(a) Current year losses and deductions	(b) Carryover amounts (column (e)) from the previous year	(c) Allowable loss from stock basis	(d) Allowable loss from debt basis	(e) Carryover amounts
35 Ordinary business loss					
36 Net rental real estate loss					
37 Other net rental loss					
38 Net capital loss					
39 Net section 1231 loss					
40 Other loss					
41 Section 179 deductions					
42 Charitable contributions					
43 Investment interest expense					
44 Section 59(e)(2) expenditures					
45 Other deductions					
46 Foreign taxes paid or accrued					
47 Total loss. Add lines 35 through 46 for each column. Enter the total loss in column (c) on line 11 and enter the total loss in column (d) on line 30					

Reconstructing Basis

The task of tracking and calculating the basis is the shareholders responsibility, however given the complexities and inclusion of items reported on the tax return the onus falls upon the tax practitioner. Unfortunately, too often basis has not been calculated for or by shareholders. Now that Form 7203 may be required it is important to reconstruct basis to move forward more accurately. The following equation may be used to determine the initial value of stock basis, (I.R.C. §358(a)):

$$\begin{aligned}
 & \text{Basis of property contributed} \\
 + & \text{ Gain recognized by shareholder} \\
 - & \text{ Boot (property other than stock) received} \\
 - & \text{ Liabilities acquired by the corporation from the shareholder} \\
 \hline
 = & \text{ Basis of stock received}
 \end{aligned}$$

When reconstructing basis, it will be necessary to ask shareholders about how they originally obtained the shares in the corporation. Was it gifted, did they buy in, did they contribute capital, was it inherited stock, would be good starting points. Once the beginning stock basis is determined, the subsequent year’s basis will rely heavily on the shareholders’ records. In the absence of good records, tax returns that have been filed may be the best source of information. Additionally, IRS transcripts may also provide valuable information to use in the reconstruction of stock basis.

How was the stock obtained?	Basis Calculation	I.R.C. or Treas. Reg.
<i>Bought it from another Shareholder</i>	Cost – how much did you pay for it	§1012
<i>Inherited</i>	FMV on date of death or alternative valuation date	§1014
<i>Gift before 01/01/1977</i>	Donor’s basis adjusted by gift tax paid or FMV on date of gift, whichever is lower	§1015(d)(1)

<i>Gift after 12/31/1976</i>	Donor's basis adjusted by gift tax paid	§1015(d)(6)
<i>Tax-free reorganization</i>	Basis of stock given up	§358(a)
<i>Compensation</i>	FMV on date included in income	Treas. Reg. §1.86-4(b)

For Example: Upon formation of Whoville Candy Shop, Cindy Lou deposited \$ 5,000 of her own money into the corporate bank account. Cindy Lou's beginning stock basis is \$ 5,000.

If Cindy Lou had deposited \$2,000 in cash and contributed \$ 3,000 (FMV) of equipment, the beginning stock basis would still be \$ 5,000.

Once an initial basis is determined the ordering rules should be applied each year the shareholder held stock in the corporation and received Schedule K-1.

1. Income items – ordinary, rental, investment, tax-exempt, separately stated, and excess depletion
2. Distributions – ordinary, NOT dividends
3. Nondeductible Expenses – noncapital or depletion
4. Losses and other separately stated loss items

Reconstructing both stock and debt basis may be a daunting task; however, it is vitally important so as not to subject taxpayers to limitations unnecessarily. One may think reconstructing debt basis should be easier than reconstructing stock basis, however sorting out historical transactions of paid-in capital versus bona-fide loan to the corporation may pose even larger challenges. Furthermore, if the shareholder reimburses the corporation for accidental use of the corporate credit card for personal expenses, is that treated as an offset to distributions or a bona-fide loan? Is it plausible that the IRS or the courts will reclassify such a transaction to paid-in capital. (*Frances B. land and James M. Gaines, as Trustee of the Bankrupt Estate of James A. Lane v. United States of America, U.S. District Court, No. dist. Ala., So. Div., 80-G-1442-S, July 6, 1983, [83-2 USTC ¶9524]*)

Below is an example of Stock & Debt Basis Worksheet.

Worksheet for Figuring a Shareholder's Stock and Debt Basis

Part 1 -- Shareholder Stock Basis

1	Stock basis at the beginning of the corporation's tax year		1	
	Basis from any capital contributions made or additional stock			
2	acquired during the tax year		2	
3a	Ordinary business income	a		
b	Net rental real estate income	b		
c	Other net rental income	c		
d	Interest income	d		
e	Ordinary dividends	e		
f	Royalties	f		
g	Net capital gains	g		
h	Net section 1231 gain	h		
i	Other income	i		
j	Excess depletion adjustment	j		
k	Tax-exempt income	k		
l	Recapture of business credits	l		
m	Other items that increase stock basis	m		
4	Add lines 3a through 3m			0.00
5	Stock basis before distributions. Add lines 1, 2, and 4		5	0.00
6	Distributions (excluding dividend distributions)		6	
	Note: If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D			
	Stock basis after distributions. Subtract line 6 from line 5. If the result is < zero, enter -0-, skip lines 8 through 14 and enter -0- on line 15			
7	-0- on line 15		7	0.00
8a	Nondeductible expenses	a		
b	Depletion for oil and gas	b		
9	Add lines 8a and 8b			0.00
	Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is < zero, enter -0-, skip lines 11 through 14, and enter -0- on line 15			
10	through 14, and enter -0- on line 15		10	0.00
11	Allowable loss and deduction items.	11		
12	Debt basis restoration	12		
13	Other items that decrease stock basis	13		
14	Add lines 11, 12, and 13			0.00
	Stock basis at the end of the corporation's tax year. Subtract line 14 from line 10. If the result is < zero, enter -0-			
15	line 14 from line 10. If the result is < zero, enter -0-		15	0.00

Once the initial stock basis is determined, the shareholder's basis worksheet can be used to calculate each of the prior year's stock and loan basis. It is important that all the Schedule K-1's received by the shareholder from the entity be used to make these computations. The IRS has noted in its presentations on this topic that the Corporations Schedule M-2 or M-2 Worksheet is not a good depiction of Shareholder stock or debt basis, except when determining beginning Stock Basis. Additionally using information from the Balance Sheet, Schedule L of the 1120S, or Balance Sheet Worksheet of the 1120S, to obtain the value of Capital Stock and/or Additional Paid-In Capital may be useful in the reconstruction of shareholder stock basis. It is important to note the percentage of ownership when utilizing the balance sheet method as the balance sheet is a total sum, not separated by percentage of ownership. The initial Schedule M-2 or M-2 Worksheet may be used as well since it reconciles Ordinary Income/Loss, other Additions, other Reductions and Non-Dividend Distributions. Unfortunately, other than the first year's basis reconstruction the corporate balance sheet and Schedule M-2 will not be useful; using the shareholder's basis worksheet will provide a more accurate calculation of stock basis.

The following examples show how to use the corporate balance sheet and Schedule M-2 to reconstruct beginning Stock Basis.

Corporate Balance Sheet (Equity)

Balance Sheet	<i>Beginning Balance</i>	<i>Ending Balance</i>
Capital Stock	45,000	60,000
Additional Paid-In Capital		
Retained Earnings	<22,000>	<86,000>

Corporate M-2

	<i>AAA (Accumulated Adjustments Account)</i>	<i>OAA (Other Adjustments Account)</i>
<i>Beginning Balance</i>	<21,000>	1,000
<i>Ordinary Income</i>		
<i>Other Additions</i>		
<i>Ordinary Losses</i>	<64,000>	
<i>Other Reductions</i>		
<i>Total</i>	<85,000>	1,000
<i>Non-Dividend Distributions</i>		
<i>Ending Balance</i>	<85,000>	1,000

Stock Basis

<i>Beginning Capital Stock</i>	45,000
<i>Additional Paid-In Capital</i>	
<i>Beginning Stock</i>	45,000
<i>AAA & OAA difference</i>	<21,000>
<i>Year-end Capital Stock</i>	24,000

Computation of stock basis: <85,000> + 1,000 + 60,000 = 24,000

Practitioner Note

Since the reconstruction of Shareholder Basis is computed at the shareholder level, the above corporate information may not be available. In the absence of other information, it is in the best interest of the shareholder to obtain or recall as much information as possible. In the absence of information Shareholder Beginning Basis is ZERO.

Court Cases

Case #1: At-Risk under §465

Jonas R. Bryan, Carmen L. Bryant v. Commissioner of Internal Revenue Service, U.S. Court of Appeals, 6th Circuit, 90-1439, March 22, 1991, [91-1 USTC ¶150,157].

The taxpayer was an investor in a silver mine, who borrowed money to fund the endeavor and asserted his investment qualifies as At-Risk under §465 without limitations. The court determined the taxpayer's investment were subject to At-Risk Limitations under §465. The court indicated that only amounts at risk are those which the taxpayer would be personally liable for or for which property was pledged (§465(b)(1)-(2) and §465(b)(4)); the taxpayer did not meet either criterion in this case.

Case #2: Revolving Debt, Capital Contribution or Loan

Frances B. Land and James M. Gaines, as Trustee of the Bankrupt Estate of James A. Lane v. United States of America, U.S. District Court, No. Dist. Ala., So. Div., 80-G-1442-S, July 6, 1983, [83-2 USTC ¶9524].

The focus of this case is whether payments made by the shareholder to the shareholders company were Advances (revolving debt), Capital Contributions, or Loans (bona-fide note). Because there was not a formal debt instrument and the shareholders did not demand repayment, the court concluded the payments were not debt. Therefore, the payments were classified as Capital Contribution. The courts also found that the debt guaranteed by the taxpayer did not qualify. At issue here was whether the taxpayer was entitled to a Bad Debt deduction on his personal tax return for the payments the shareholder made to the company. The court did decide

that the guaranteed debt for which the shareholders had made payments was eligible for Capital Loss treatment. The court used the following factors to determine At-Risk Limitations:

1. The names given to the certificates evidencing the indebtedness;
2. The presence or absence of a fixed maturity date;
3. The source of payment;
4. The right to enforce payment of principal and interest;
5. Participation in management flowing as a result;
6. The status of the contribution in relation to regular corporate creditors;
7. The intent of the parties;
8. “Thin” or adequate capitalization;
9. Identity of interest between creditors and stockholders;
10. Source of interest payments;
11. The ability of the corporation to obtain loans from outside lending institutions;
12. The extent to which the advance was to acquire capital assets; AND
13. The failure of the debtor to repay on the due date or to seek a postponement.

The court found the taxpayer failed the tests and that “the advances concerned in this case are contributions to capital, not bona-fide loans...” even though there was a realistic expectation of repayment regardless of the success of the business.

Case #3: Personal Guarantee & Circuit Conflicts

Lawrence R. Uri, Jr. and Cathaleen T. Uri v. Commission of Internal Revenue, Stevens J. Townsdin and Renate Townsdin v. Commissioner of Internal Revenue, U.S. Court of Appeals, 10th Circuit, 89-9014, 89-9015, November 18, 1991, [91-2 USTC ¶50,556] (56 TCM 1217, Dec. 45-475(M), TC Memo 1989-58)

The taxpayers/shareholders personally guaranteed debt of the corporation, however they did not make any payments on behalf of the corporation. The taxpayers/shareholders asserted they had bona-fide debt basis and were entitled to losses to the extend of stock and debt basis. The court disagreed citing the shareholders had not made payments on the debt nor were they

asked to make payments on behalf of the corporation under §1374. The taxpayers/shareholders further argued they were entitled to an adjustment to basis because the corporation would not have been able to ascertain a loan if they had not guaranteed the debt in the first place. The court disagreed citing I.R.C. §1012 and Treas. Reg. §1.102-1(a)

This case is most interesting because it notes the conflicts amongst circuits in handling shareholders who personally guarantee corporate debt. The 11th Circuit uses a pro-rata approach indicating that without a personal guarantee of the shareholder the corporation would not be able to receive a loan, as the taxpayers/shareholders asserted in this case. However, the 4th, 5th and 6th Circuits indicate shareholders must make the payments on behalf of the corporation to received debt basis, Treas. Reg. 1.1366-2. The 10th Circuit, which is this cases circuit, held that the “personal guarantees were neither cash nor other property” and therefore did not qualify for adjustments to stock or debt basis.

About the Author

Mary Jane has a Master of Management from Walsh College of Accountancy and Business Administration as well as Bachelor of Science from Eastern Michigan University in Public Administration with a focus on Organizational Development and Governmental Accounting. Mary Jane has been practicing since 1993 working at a couple larger Tax, Accounting & Audit Firms in the area before transitioning to her own practice in 2005.

She is an Instructor of Tax for Michigan State University Tax School and Clemson University Tax School. Mary Jane is a Contributing Editor and Author of the National Tax Workbook for the Land Grant University Tax Education Foundation. She has written and compiled course packs used by Michigan State University Tax School, as well as Clemson University Tax School. Mary Jane is also an author/speaker for several national CPE providers, including Professional Education Management, CPE Today and Werner-Rocco Seminars Ltd. She is a previous speaker for the Michigan Chapter of the National Association of Tax Professionals, the Michigan Society of Enrolled Agents, several local financial events as well as a former H&R Block Instructor/Trainer.

Mary Jane is credentialed as an Internal Revenue Service Enrolled Agent, allowing her to practice before the IRS. With this credential, she has direct oversight by the IRS Office of Professional Responsibility. She is also an NTPI Fellow.

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