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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Edward D. Fickess
ASSOCIATE AREA COUNSEL, CC:SB:1:BUF

FROM: Associate Chief Counsel (Passthroughs & Special Industries)
CC:PSI

SUBJECT: 1120S Basis

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ISSUE

Must the basis of the stock of an S corporation in an open year be computed using previously deducted losses in excess of the basis in the stock in a year that is now closed?

CONCLUSIONS

We conclude that the basis of the stock of an S corporation in an open year must be computed using previously deducted losses in excess of the basis in the stock in a year that is now closed.

FACTS

A is the 100% shareholder of Corp, which is an S corporation. In Year 1 Corp had $50,000 in capital losses and A had an adjusted basis of $20,000 in his Corp stock. On his individual income tax return for Year 1, A deducted the entire $50,000 capital loss and reduced his basis in his Corp stock to zero. In Year 2, Corp had an ordinary loss of $30,000. On his tax return for Year 2, A deducted the $30,000 ordinary loss and A claimed that his adjusted basis remained at zero. In Year 3 Corp had $90,000 of ordinary income. A claims that his basis in his S corporation stock at the end of Year 3 was $90,000. Corp's Year 1, Year 2, and Year 3 tax years are now closed under the statute of limitations for assessment. Year 4 is open under the statute of limitation and is currently under examination.

LAW AND ANALYSIS

Section 1366(a) of the Internal Revenue Code provides that in determining a shareholder's tax liability for the shareholder's taxable year in which the taxable year of the S corporation ends, there is taken into account the shareholder's pro rata share of the corporation's: (1) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and (2) nonseparately computed income or loss.

Section 1366(d)(1) provides that the aggregate amount of losses and deductions taken into account by a shareholder under section 1366(a) for any taxable year may not exceed the total of the shareholder's adjusted basis in stock of the S corporation and the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder.

Section 1366(d)(2) provides an indefinite carryover of losses and deductions that are disallowed because of insufficient basis. Such disallowed losses and deductions are to be treated as incurred by the S corporation in the succeeding taxable year with respect to the shareholder.

Section 1367(a) provides that the basis of a shareholder's S corporation stock is increased by its share of the S corporation's income and decreased (but not below zero) by its share of the S corporation's losses and deductions.

Section 6214(b) provides that facts from closed years may be considered to correctly redetermine the amount of the deficiency for the year before the Tax Court, but in so doing the court shall have no jurisdiction to determine whether or not the tax for any other year has been overpaid or underpaid.

Section 1.1016-6(a) of the Income Tax Regulations provides that adjustments to basis must always be made to eliminate double deductions or their equivalent. Section 1.1016-6(b) provides that in determining basis, and adjustments to basis, the principles of estoppel apply, as elsewhere under the Code, and prior internal revenue laws.

Generally, the basis of S corporation stock is adjusted by its share of the S corporation's tax items. This adjustment is made each year and the basis of S corporation stock cannot be reduced below zero. If the shareholder's share of losses is in excess of his basis in the stock, then the shareholder must create a suspense account, pursuant to § 1366(d)(2), consisting of these excess losses.

In the instant case, for the Year 1 and Year 2 tax years A's share of Corp's losses were in excess of A's basis in the stock of Corp and A incorrectly deducted the losses in excess of basis on his individual tax returns. A's basis cannot be reduced below zero and the Service is barred by the statute of limitations from disallowing these losses. If A had correctly reported his share of tax items of Corp, A would have deducted only $20,000 for Year 1 and Year 2, and the $60,000 of excess losses would be held in a suspense account to be used in future years. In Year 3, A reported his share of Corp's income and increased the basis in his Corp stock by this income. For Year 3, A's income and basis in his stock should have been reduced by the amount in his suspense account.

Section 6214(b) allows for a computation of tax items of an open year using facts from closed years. The Tax Court has held that for purposes of determining a taxpayer's deficiency for an open year using income averaging, the Service may increase the taxpayer's taxable income for the base period years even though the base period years were closed. Nona Lou Greene, Conservatee v. Commissioner, T.C. Memo. 1992-202. Courts have also used facts from closed years to compute the amount of net operating losses for an open year. Leitgen v. Commissioner, 82-2 U.S.T.C. ¶ 9553 (8th Cir. 1982), aff'g T.C. Memo. 1981-525 (1981) (Substantiation of claimed 1972 NOL was considered in determining whether loss was available to be carried forward to 1973, 1974 and 1975); Lone Manor Farms, Inc. v. Commissioner, 61 T.C. 436, 440 (1974), aff'd without published op., 510 F.2d 970 (3d Cir. 1975) (NOLs available for use in 1967 could not be used in 1969).

In the present case, although Year 1 and Year 2 are closed for determining a tax deficiency based on the excess losses, the correct determination of gains and losses from the closed years must be used for the purpose of determining the correct basis in the first open year. A's basis in his Corp stock must be computed taking into account the excess losses from Year 1 and Year 2. Therefore A's basis in his Corp stock is $30,000 at the beginning of Year 4, which takes into account the amount of income from Year 3 reduced by the amount of excess losses from Year 1 and Year 2.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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If you have any further questions please call