S-Corporation Shareholder Basis

By: Renee Daggett

General Definition:

If you have ownership in an S-corporation it is important to have a general understanding of basis. This number called “basis” increases and decreases with the activity of the company. The IRS defines it as the amount of one’s investment in the business for tax purposes. When the S-corporation files a tax return (1120S), all shareholders receive a K-1 form to show profits, losses and deductions allocated to the shareholder. The K-1 does not state the taxable amount of the distribution, which is contingent on the stock basis. The main purpose of basis is to determine if distributions are taxable or losses are deductible. The basis for each shareholder is calculated annually and must be tracked from day 1 of ownership.

Importance of Basis:

It is important to calculate the basis for the following reasons:

- If the shareholder receives a distribution and has basis to cover the amount, the withdrawal is not taxable to the shareholder.
- If the shareholder has a loss in the company and has basis to cover the amount, the losses will be allowed to be taken in that tax year.
- When the shareholder disposes of his/her stock, gain or loss on the disposition is calculated using the shareholder’s stock basis.

How Basis is Calculated:

Think of basis like a checking account. The account goes up and down, but can never go negative. When there is a deposit of income, the basis goes up for all shareholders based upon percentage of ownership. When there is a payment of an expense, the basis goes down. When a shareholder contributes money to the company, the basis goes up. When a shareholder withdraws money, the basis goes down. Basis is also decreased by several activities like penalties the company had to pay, section 179 deductions on assets or the non-deductible portion of meals and entertainment. (So be aware that all the meals you eat out on the company’s dime actually “eat up” half of your basis!)

In year 1, you start out with a zero basis. For the activity of the first year in business, you then have an ending basis. This ending basis in year 1 is your beginning basis number for year 2. This continues as long as a personal has ownership in a company.

There is an ordering rule of how the basis is calculated (what numbers are adjusted first, next and last), but I won’t go into further explaining since it is more complicated.

Please see the last page of this article for a sample of a Shareholder’s Basis Worksheet.

Suspended Losses:

Normally a shareholder that has basis in the company can reduce their other income (W-2 wages, interest, dividends, rental, etc.) on their personal tax return with the losses of the company. This is a really nice advantage of the S-corporation! However, if the shareholder does not have basis to go against that loss, the loss is suspended and disallowed for that tax year to offset other income. The losses are carried over indefinitely until the shareholder has more basis.

Distributions:

In general, if a shareholder withdraws money from the company outside of payroll, the distribution will only reduce the basis in the company. This is another benefit of an S-corporation! Regular corporations (C-corps) tax the shareholder for pulling out money, called dividends. You've probably heard the phrase, "double taxation on C-corps". In an S-corp, that does not happen if you have basis. So what happens if you don't have basis and you pull money out? The amount that exceeds the basis will be taxed as a capital gain on the shareholder's personal return. Here is an example:

Beginning Stock Basis =	$25,000
Current year Loss =	$-20,000

Ending Stock Basis =	$5,000
Distributions =	$10,000

Distribution Above Basis	$5,000 = this is the amount the shareholder will be taxed at the capital gains rate!

So now do you see why tracking basis is important?

Reconstructing Basis:

When you change tax preparers, a good sign that they are competent is if they ask for your basis schedules the first year they prepare your return. If they do not have the schedule, they will need to recreate it from year 1. Reconstructing the basis is not very difficult as long as all the K-1's and records are available for every year in business.

Even if a company has been tracking basis, it does not necessarily mean that the numbers are correct. Remember garbage in, garbage out holds true for basis schedules.

Two Types of Basis:

There are two types of basis numbers that need to be tracked: stock basis and debt basis. Most of what you read above is stock basis. However, debt basis is a tad more complicated. For a shareholder to receive debt basis, the shareholder must make a direct loan to the corporation. The shareholder bears some risk in loaning the company money. Always have a promissory note and collect interest on the loan. Repayments of the loan are calculated against the debt basis. If the shareholders stock basis is zero, then losses are still allowed if there is debt basis. If the debt is repaid before the stock basis is restored, then all or part of the repayment of the loan may be taxable.

The End in Mind:

Every shareholder should be thinking of the end of the year. What is done before December 31 is tax planning and every owner should be strategizing so there are no surprises come tax time.

2011 Shareholder's Basis Computation

S Corporation Name	Employer I.D. number
Name of Shareholder	**Shareholder's I.D. number**
FRED FLINTSTONE	999-99-9999

1. **STOCK BASIS AT BEGINNING OF TAX YEAR**	

INCREASES:		**DECREASES:**	
2. Ordinary income		13. Nondeductible expenses	
3. Net income from rental activities		14. Oil and gas depletion	
4. Net portfolio income		15. Ordinary loss	
5. Net gain under Section 1231		16. Net loss from rental activities	
6. Other income		17. Net portfolio loss	
7. Tax-exempt interest income		18. Net loss under Section 1231	
8. Other tax-exempt income		19. Other loss	
9. Net gain on disposition of Section 179 assets		20. Charitable contributions	
10. Oil and gas depletion in excess of basis		21. Section 179 expense deduction	
11. OTHER INCREASES:		22. Deductions related to portfolio income (loss)	
		23. Other deductions	
		24. Investment interest expense	
		25. Total foreign taxes	
		26. Section 59(e) expenses	
		27. Prior year loss in excess of basis	
		28. OTHER DECREASES:	
		29. Property distributions (including cash)	
12. **TOTAL INCREASES:** (add lines 2 - 11)		30. **TOTAL DECREASES** (add lines 13 - 29)	0.

31. **STOCK BASIS AT END OF TAX YEAR.** (Line 1 plus line 12 minus line 30)	0.
32. **DEBT BASIS AT BEGINNING OF TAX YEAR**	0.
33. **ADJUSTMENTS TO DEBT BASIS:**	
34. **DEBT BASIS AT END OF TAX YEAR** (Combine Line 32 and 33)	0.
35. **SHAREHOLDER'S TOTAL BASIS AT END OF TAX YEAR** (Add Line 31 and 34)	0.