



BUSINESS ENTITY TAX ISSUES

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LEARNING OBJECTIVES

After completing this session, participants will be able to perform the following:

- ✓ Understand the tax consequences of a partnership interest sale
- ✓ Know how redemption of a partnership interest is taxed
- ✓ Calculate S corporation stock and loan basis
- ✓ Know when an S corporation shareholder must file Form 7203, S Corporation Shareholder Stock and Debt Basis Limitation
- ✓ Calculate the gain on repayment of an S corporation shareholder loan that has a reduced basis
- ✓ Understand how to complete Form 7203

- ✓ Know the eligibility requirements for I.R.C. § 501(c)(6) business leagues
- ✓ Understand the tax-filing obligations for a section 501(c)(6) organization
- ✓ Recognize when a partnership or corporation with no foreign partners or foreign income must file Schedules K-2 and K-3 (Forms 1065 and 1120-S)

INTRODUCTION

Liquidation of a partner's entire interest in a partnership can be structured as a purchase of the interest by the remaining partners or a third party, or a redemption of the partner's interest by the partnership. This chapter reviews the different tax treatment of a sale and a redemption.

Beginning in tax year 2021, an S corporation shareholder may have to file Form 7203, S Corporation Shareholder Stock and Debt Basis

Limitation. This new form reports the shareholder's basis in his or her shares and also debt basis so that the IRS can verify compliance with reporting distributions, and the S corporation loss limitation rules. This chapter explains how to determine a shareholder's adjusted basis, and how to complete Form 7203.

Rev. Proc. 2022-19, 2022-41 I.R.B. 282, provides new procedures that allow S corporations and their shareholders to resolve frequently encountered eligibility issues, without requesting a private letter ruling. This chapter discusses how the revenue procedure provides relief from inadvertent invalid S elections or terminations.

I.R.C. § 501(c)(6) provides tax-exempt status for business leagues, chambers of commerce, real estate boards, boards of trade, and professional football leagues. These organizations can engage in a wide range of activities to promote and improve their industry or profession, including lobbying, networking, education,

and research. Tax practitioners must recognize when an organization meets the requirements for section 501(c)(6) tax-exempt status and the requirements to maintain that status. This chapter explains eligibility for tax-exempt status and reviews the organization's tax-filing obligations. This chapter also explains how a tax practitioner can help a section 501(c)(6) organization apply for reinstatement after its tax-exempt status was revoked for failure to file its annual returns.

A partnership or S corporation with no foreign owners, no foreign source income, no assets generating foreign source income, and no foreign taxes paid or accrued may still need to report information on Schedules K-2 and K-3 (Forms 1065 and 1120-S). This section briefly explains the filing requirements, and it also explains the domestic filing exception that relieves certain partnerships and S corporations of the obligation to file and furnish Schedules K-2 and K-3.

ISSUE 1: PARTNERSHIP INTEREST SALE VS. REDEMPTION

Tax consequences of the sale of a partnership interest and the redemption of a partnership interest differ.

Liquidation of a partner's entire partnership interest can be structured as a purchase of the interest by the remaining partners or a third party, or a redemption of the partner's interest by the partnership. In either structure, the retiring partner receives cash and/or property in exchange for his or her partnership interest. However, the tax consequences to the retiring partner and the remaining partners differ.

This section reviews the different tax treatment of a sale and a redemption. This discussion refers to a partnership but is also applicable to the sale or redemption of an interest in a multi-member LLC taxed as a partnership (except with regard to the impact of liabilities, which are generally nonrecourse to LLC members).

Sale of a Partnership Interest

Under the I.R.C. § 741 general rule, the sale of a partnership interest is treated as a sale of a capital asset, resulting in capital gain or loss for the selling partner. The gain or loss on the sale is the difference between the amount realized and the partner's outside basis (the partner's adjusted basis in contributed assets plus cash contributed to the partnership). Each partner's share of partnership liabilities is treated as a cash contribution and increases outside basis. A reduction in the selling partner's share of partnership liabilities is included in the amount realized. The purchaser takes a cost basis in the purchased interest.

An exception to the section 741 general rule exists when the partnership holds certain types of ordinary income assets. A look-through concept is applied and the selling partner may have to characterize part of the gain or loss on the sale of the interest as ordinary gain or loss. An additional look-through rule may characterize part of

the gain as unrecaptured section 1250 gain or collectibles gain.

PRACTITIONER NOTE

Related Party Sales

The tax practitioner must identify if the sale is to a related party because the tax treatment of sales of partnership interests to a related party versus an unrelated party differs. For example, a loss on a sale of a partnership interest to a related party is not allowed, and gains recognized are ordinary.

Section 751(a) Assets

I.R.C. § 751 was enacted to prevent the conversion of ordinary income into capital gain and the shifting of ordinary income among partners. When the partnership owns section 751 assets, the selling partner must recognize ordinary gain or loss attributable to the partner's share of those assets. Only the excess, if any, of the purchase price over the amount characterized as ordinary income or loss is treated as capital gain.

Section 751(a) recharacterizes capital gain or loss when an interest in a partnership is sold or exchanged to the extent of the selling partner's share of unrealized receivables and inventory items ("hot assets") of the partnership. Section 751(b) (discussed later) applies to certain current and liquidating partnership distributions that change a partner's share of unrealized receivables (including sections 1245 and 1250 depreciation recapture) and substantially appreciated inventory items (disproportionate distributions).

Unrealized Receivables and Inventory

Under section 751(c), unrealized receivables include the right to payment for goods and services, including goods to be delivered and services to be rendered. Unrealized receivables also include amounts that would be recaptured as ordinary income on a sale of partnership property for fair market value, such as I.R.C. §§ 1245 and 1250 recapture income.

Under section 751(d), inventory is property described in I.R.C. § 1221(a)(1) (stock in trade of the taxpayer or other property that would properly be included in the inventory of the taxpayer if on hand at the end of the tax year, or property held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business). Inventory also includes any other property that, if sold, would not be a capital asset or I.R.C. § 1231 property.

Deemed Sale of Hot Assets

If a partner sells his or her interest in a partnership that has hot assets, the amount characterized as ordinary gain or loss is determined by calculating the gain or loss from section 751(a) property that would be allocated to the selling partner if the partnership sold those assets for fair market value. That amount is ordinary gain or loss on the sale of the partnership interest. The remainder of the gain is capital gain.

Example 11.1 Partnership Interest Sale with Hot Assets

Continental Divide Partnership has three equal owners. One of the partners, Renee Nelson, has a \$50,000 outside basis in the partnership. The partnership has no liabilities. If Renee sells her partnership interest for \$100,000, and the partnership has no hot assets, Renee has a \$50,000 (\$100,000 – \$50,000) capital gain.

If instead the partnership has inventory, Renee must determine her portion of the gain attributable to a deemed sale of the inventory. If the inventory has a \$30,000 basis and a \$45,000 fair market value (FMV), Renee's share of the

deemed gain on a sale of the inventory is \$5,000 $[(\$45,000 - \$30,000) \div 3]$. Renee must characterize \$5,000 of her gain as ordinary income, and the remaining \$45,000 ($\$50,000 - \$5,000$) is capital gain.

Look-Through Gains

Capital gains are further broken down by the category of the gain. On the sale of a partnership interest held for more than 1 year, the selling partner must take into account the partner's share of unrecaptured section 1250 gain [Treas. Reg. §1.1(h)-1(b)(3)(ii)]. Section 1250 gain has a 25% maximum tax rate which is higher than the maximum 20% capital gains tax rate. A similar rule applies to collectibles gain, which is taxed at a maximum 28% rate.

Example 11.2 Unrecaptured Section 1250 Gain

Two Rivers Partnership has three partners. Alex owns 20%, Bella owns 40%, and Chad owns 40%. Bella sells her 40% interest to Chad for \$400,000. The FMV of the partnership is \$1,000,000, and it has no section 751(a) gain or liabilities. Bella has a \$320,000 outside basis and an \$80,000 ($\$400,000 - \$320,000$) gain. The partnership owns a building with a \$1,480,000 ($\$1,560,000$ initial cost – \$80,000 accumulated depreciation) inside basis and a \$1,670,000 FMV.

The unrecaptured section 1250 gain is the amount of the depreciation taken on the property, limited to the actual gain on the sale. The total gain on the sale of the building would be \$190,000 ($\$1,670,000 - \$1,480,000$). Thus, the unrecaptured section 1250 gain is limited to the \$80,000 depreciation deductions. Bella owns a 40% interest, and her share of unrecaptured section 1250 gain from the building is \$32,000 ($\$80,000 \times 40\%$). Bella's \$32,000 gain is taxed at a maximum 25% rate, and her remaining \$48,000 ($\$80,000 - \$32,000$) gain is taxed at regular capital gains rates.

Installment Sale

If the purchase price for the partnership interest is paid to the selling partner in more than one tax year, the selling partner recognizes gain or loss as payments are made. The seller can elect out of the installment sale method. The installment sale method is not available for certain sales, such as inventory, receivables, and recapture. Thus, the taxpayer can sell a partnership interest on the installment sale method, but the income from the deemed sale of assets that are not eligible for installment reporting must be reported immediately [Rev. Rul. 89-108, 1989-2 C.B. 100; see also C.C.A. 200722027 (April 27, 2007)].

CROSS-REFERENCE

Basis Adjustment Election

When the buying partner acquires the partnership interest at FMV, the partner's outside basis in the partnership interest likely differs from the partner's share of the partnership's inside basis in its assets. The partnership can elect under I.R.C. § 754 to make an I.R.C. § 743(b) basis adjustment, and the buying partner will receive to an adjustment in his or her share of the partnership's assets attributable to the acquired interest. See pages 265–274 in the *2022 National Income Tax Workbook* for a discussion of the election.

Redemption of a Partnership Interest

Distributions in redemption of a partnership interest are typically taxed under the general distribution rules [I.R.C. § 736(b)]. If the partnership has hot assets, section 751(b) may characterize a part of the gain or loss as ordinary. Certain payments to a general partner in a service partnership are taxed differently under I.R.C. § 736(a).

Section 736(b) Payments

I.R.C. § 736(b) liquidating payments to retiring partners are taxed under the general partnership distribution rules. With a limited exception for certain payments to a retiring or deceased general partner in a service partnership, all payments made in the liquidation of the interest of a retiring partner or a deceased partner are treated as section 736(b) payments.

Under the general partnership distribution rules, the retiring partner recognizes capital gain or loss to the extent the cash received is greater or less than the retiring partner's basis in his or her partnership interest. The general rule for cash distributions (current or liquidating) is that they reduce the capital account and the basis in the recipient partner's partnership interest as of the date of the distribution. If the distribution exceeds the partner's adjusted basis in the partnership interest, the distribution is taxable [I.R.C. § 731].

For fixed sum payments made in liquidation of the entire partnership interest of a retiring or deceased partner, the recipient can elect to recover basis ratably as payments are received, except to the extent that section 751 applies to hot assets [Treas. Reg. § 1.736-1(b)(6)].

PRACTITIONER NOTE

Liability Relief

In an installment sale of a partnership interest, relief from liabilities of the partnership is a payment in the year of the sale. Distributions to a retiring partner can defer income from that section 752(b) deemed distribution.

Section 751(b) Assets

If the partnership assets include unrealized receivables or substantially appreciated inventory items, part of the redemption payment is ordinary income attributable to the deemed sale of such assets by the partnership that would be allocable to the retiring partner. With limited exceptions, section 751(b) treats the following distributions as sales or exchanges:

1. A partner receives a distribution of unrealized receivables or substantially appreciated inventory in exchange for all or part of the partner's interest in other partnership property (including money).
2. A partner receives a distribution of partnership property (including money) in exchange for all or part of the partner's interest in the partnership's unrealized receivables or substantially appreciated inventory (defined next).

This rule is narrower than the rule for hot assets (described earlier) on the sale of partnership interests because it applies to inventory items only if they are substantially appreciated. For distributions, inventory is substantially appreciated if the FMV of all inventory items is more than 120% of the partnership's aggregate adjusted basis in the inventory (without regard to any special basis adjustment of any partner), and the FMV of the inventory exceeds 10% of the FMV of all partnership property other than money [Treas. Reg. § 1.751-1(d)].

Example 11.3 Disproportionate Distribution of Hot Assets

Ginger Restaurant Group (GRG) has three equal partners: Anne Chien, Jasmine Ho, and Win Bowden. Each partner has a \$150,000 outside basis. Figure 11.1 shows the GRG assets.

FIGURE 11.1
GRG Assets

Asset	Basis	FMV
Cash	\$300,000	\$300,000
Inventory (substantially appreciated)	90,000	150,000
Capital assets	60,000	150,000
Total assets	<u>\$450,000</u>	<u>\$600,000</u>

In complete liquidation of Anne's interest, the partnership distributes \$200,000 cash to her. Before the distribution, Anne had a \$50,000 ($\$150,000 \div 3$) FMV and a \$30,000 ($\$90,000 \div 3$) outside basis in hot assets (the substantially appreciated inventory). After the distribution, Anne has no interest in the inventory. There is a deemed distribution of \$50,000 inventory to Anne, and then Anne is deemed to sell the inventory to the partnership for \$50,000 cash. The distribution reduces Anne's basis to \$120,000 ($\$150,000 - \$30,000$). Anne has \$20,000 ($\$50,000 \text{ cash} - \$30,000 \text{ basis}$) ordinary gain on the deemed sale, and she has a \$30,000 ($\$150,000 \text{ distribution} - \$120,000 \text{ basis}$) capital gain on the remaining liquidating distribution.

Section 736(a) Payments

Under I.R.C. § 736(a), amounts paid to a retiring or deceased general partner in a service partnership for unrealized receivables (excluding recapture items) or goodwill are treated as the retiring partner's distributive share of partnership income if the payment is determined based on the partnership's income. The payments are included in the retiring partner's income under I.R.C. § 702 and will typically be subject to self-employment (SE) tax. The distributions reduce the distributable share of the remaining partners.

If the redemption amount is not based on the partnership's income, it is a guaranteed payment and is deductible by the partnership. Guaranteed payments are ordinary income to the retiring partner and subject to SE tax.

The section 751(b) rule that characterizes gain on a disproportionate distribution of hot assets as ordinary income does not apply to section 736(a) payments [I.R.C. § 751(b)(2)(B)].

PRACTITIONER NOTE

Redemption of Goodwill

Service partnerships can treat redemption payments that are attributable to goodwill as either a section 736(a) payment or a section 736(b) payment, depending on whether the partnership agreement specifically provides for goodwill payments. A payment for goodwill under section 736(a) is a guaranteed payment. It is ordinary income to the retiring partner and deductible by the partnership.

Comparison of a Redemption with a Sale

Figure 11.2 compares a section 736(b) redemption with a section 741 sale of a partnership interest.

FIGURE 11.2
Section 736(b) Redemption and Section 741 Sale Comparison

	736(b) Redemption	741 Sale
General tax consequences to seller	Capital gain or loss; ordinary for section 751 assets	Capital gain or loss; ordinary for section 751 assets
Subject to SE tax	No	No
Inventory taxed as ordinary income	Substantially appreciated inventory	All inventory
Recognition of ordinary income from hot assets	Ratable distribution*	In year of sale, even if treated as an installment sale
Unrecaptured 1250 gain	No tax on share of section unrecaptured 1250 gain	Maximum 25% tax rate applies to unrecaptured 1250 gain
Basis recovery (nonhot assets)	Recover full basis before recognizing gain	Pro rata basis recovery under installment sale
General tax consequences to partnership/buyer	Generally, delayed step-up as retiring partner recognizes gain, unless section 751 deemed sale or retiring partner elects to recover basis ratably	Cost basis in purchased interest—year 1
Imputed interest rules apply	No	Yes
Payments deductible by payer	No, [unless 736(a) guaranteed payment], but reduces distributable income	No
Liability relief included in income	Potentially deferred	Included in year of sale

* Section §736(b) payments are first allocable to the deemed section 751 exchange. Thus, when a partnership makes liquidating distributions in installments, under the general distribution rules, the retiring partner has ordinary income on each distribution that is a disproportionate distribution of hot assets. If the payments are fixed, some commenters suggest that the deemed section 751(b) exchange takes place at the onset of the payments, resulting in recognition of all the ordinary income from hot assets in the first year.

PRACTITIONER NOTE

Conflict of Interest

When choosing a sale or a redemption, the interests of the retiring partner often do not align with the interests of the remaining partners. Tax practitioners must consider the extent to which there may be a conflict of interest.

ISSUE 2: S CORPORATION SHAREHOLDER BASIS

This section reviews how to determine a shareholder's basis in an S corporation and how to report that basis.

Shareholder basis determines whether an S corporation shareholder can receive tax-free distributions and deduct losses. For purposes of the loss limitation rules, the shareholder's basis includes not only the basis in stock but also the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (debt basis) [I.R.C. § 1366(d)(1)].

Beginning in tax year 2021, an S corporation shareholder may have to file Form 7203, S Corporation Shareholder Stock and Debt Basis Limitation. This new form reports the shareholder's basis in his or her shares and also debt basis so that the IRS can verify compliance with reporting distributions, and the S corporation loss limitation rules.

This section explains how to determine a shareholder's adjusted basis. It also discusses who must file Form 7203 and how to complete the form.

Stock Basis

The starting point for determining a shareholder's stock basis is the shareholder's acquisition basis. Acquisition basis is adjusted each year by the shareholder's share of the corporation's income, deductions, and losses. Basis is also reduced by distributions to the shareholder (other than dividends from accumulated earnings and profits if the corporation was a C corporation or acquired C corporation attributes).

Acquisition Basis

If the shareholder received the stock in an I.R.C. § 351 tax-free incorporation, the shareholder's basis in the S corporation stock is generally the basis in the property contributed to the corporation in exchange for the stock [I.R.C. § 358].

The initial basis for a shareholder that purchased the stock is its cost [I.R.C. § 1012]. If the shareholder received the stock from a decedent, the basis is typically the fair market value (FMV) of the stock on the date of the decedent's death or on the alternate valuation date [I.R.C. § 1014]. However, if the shareholder inherited S corporation stock after August 20, 1996, he or she must reduce basis in the stock by the portion of the value of the stock that is attributable to items that constitute income in respect of the decedent [I.R.C. § 1367(b)(4)(B)].

If the shareholder received the stock as a gift after 1976, the shareholder's basis is the donor's basis increased by gift tax paid, limited to gift tax attributable to stock appreciation in the hands of the donor. If the FMV of the stock was less than the donor's basis at the time of the gift, for purposes of determining a loss, the donee's basis is the FMV on the date of the gift. If the shareholder received the stock as compensation, the initial basis is its FMV, which must be included in the shareholder's gross income [Rev. Rul. 67-402, 1967-2 C.B. 135].

PRACTITIONER NOTE

Income in Respect of a Decedent

Common items of income in respect of a decedent (IRD) are cash basis accounts receivable and deferred gains on installment receivables. A successor shareholder must reduce stock basis from its estate tax value by the portion of IRD items attributable to the decedent's shares. Corresponding deductions are allowed for cash method accounts payable and estate taxes imposed on the IRD items [I.R.C. § 691(b) and (c)]. Without these reductions in basis, S corporation shareholders would get the benefit of a basis adjustment for the IRD.

Adjusted Basis

Stock basis is adjusted annually, as of the last day of the tax year (or immediately before the disposition of S corporation stock). Under the general rules, for tax years beginning on or after August 18, 1988, adjustments are made in the following order:

1. Income items, including tax-exempt income and separately stated income, and excess depletion increase basis.
2. Distributions (other than dividends from the corporation's accumulated earnings and profits) decrease basis, but not below zero.
3. Nondeductible, noncapital expenses, and depletion decrease basis, but not below zero.

4. Items of loss and deduction decrease basis, but not below zero.

Example 11.4 Stock Basis Reduced by Loss and Distribution

Beta Corp. is an S corporation with one shareholder, Birdie Addison. Birdie's stock basis at the beginning of 2023 was \$20,000. In 2023, Beta reported \$75,000 ordinary income and distributed \$50,000 to Birdie. Beta has always been an S corporation, and it has no accumulated earnings and profits. **Figure 11.3** shows the order in which the income and distribution adjust Birdie's stock basis.

FIGURE 11.3
Order of Stock Basis Adjustments

Birdie's stock basis at beginning of 2023	\$20,000
Step 1: Add current-year income items	75,000
Step 2: Subtract 2023 distributions	(50,000)
Birdie's stock basis at end of 2023	<u>\$ 45,000</u>

CROSS-REFERENCE

Elective Ordering Rule

Under Treas. Reg. § 1.1367-1(g), a shareholder can elect to decrease basis by items of loss or deduction before the shareholder decreases basis by noncapital nondeductible expenses. If a shareholder makes this election, any amount of nondeductible expenses that exceeds the shareholder's basis in stock and indebtedness is treated, for purposes of calculating basis, as nondeductible expenses in the next tax year. See pages 120–121 in the *2020 National Income Tax Workbook* for a discussion of when use of the elective ordering rule may be advantageous.

S Corporation Debt Basis

An S corporation shareholder obtains debt basis by making a direct loan to the S corporation. The shareholder must have an actual economic outlay to obtain debt basis, and merely guaranteeing an S corporation loan from a third party does not immediately increase a shareholder's stock basis.

When a shareholder makes a payment on bona fide indebtedness of the S corporation for which the shareholder has acted as guarantor or in a similar capacity, the shareholder may increase the basis of his or her indebtedness to the extent of that payment.

CROSS-REFERENCE

Debt Basis

Most courts have held that the loan must run directly between the corporation and the shareholder and there is no attributed basis for loans made by related parties. See pages 121–123 in the *2020 National Income Tax Workbook* for a discussion of loans that create S corporation debt basis.

Adjustments to Debt Basis

If a shareholder's allocation of S corporation losses never exceeds the shareholder's stock basis, there is never an adjustment to debt basis. If, however, the shareholder's loss allocation exceeds the stock basis, debt basis is adjusted as follows:

1. In the year of the loss, after stock basis is reduced to zero, the shareholder reduces debt basis.

2. In a subsequent year when the corporation reports income and the shareholder has a net increase in basis, the shareholder restores debt basis before increasing stock basis.

Example 11.5

Loss Adjustment to Debt Basis

Lewiston, Inc. is an S corporation with one shareholder, George Lewiston. At the beginning of 2022, George had a \$60,000 stock basis and a \$50,000 debt basis for a loan that George had made directly to the corporation. The debt is evidenced by a promissory note. The corporation reported a \$100,000 ordinary loss in 2022. In 2023, the corporation reported \$140,000 of ordinary income.

The 2022 loss first eliminated George's \$60,000 stock basis. The remaining \$40,000 (\$100,000 – \$60,000) loss then reduced his debt basis to \$10,000 (\$50,000 – \$40,000). In 2023, the first \$40,000 of the corporation's \$140,000 income restores George's debt basis to its \$50,000 face value. The remaining \$100,000 (\$140,000 – \$40,000) income then increases his basis in the stock. The adjustments to George's stock and debt basis are shown in **Figure 11.4**.

FIGURE 11.4
Adjustments to George's Stock and Debt Basis

Adjustments	Stock Basis	Debt Basis	Total Basis
2022 beginning basis	\$60,000	\$50,000	\$110,000
2022 loss	(60,000)	(40,000)	(100,000)
2022 ending basis	\$0	\$10,000	\$10,000
2023 income	100,000	40,000	140,000
2023 ending basis	<u>\$100,000</u>	<u>\$50,000</u>	<u>\$150,000</u>

Repayment of Shareholder Loans

Corporate repayment of a loan owed to an S corporation shareholder reduces the shareholder's basis in the loan and only loans that are outstanding at the end of the year provide basis for losses. When basis in a shareholder's loan has been reduced by prior losses, repayment of the loan is a taxable event. If there is a partial repayment, it is proportionately allocated between basis and gain.

Capital Gain

Repayment of a loan evidenced by a written instrument is treated as the sale or exchange of a capital asset. In Rev. Rul. 64-162, 1964-1 C.B. 304, the taxpayer loaned money to an electing small business corporation. The shareholder's share of the corporate losses reduced his stock basis to zero and then reduced the shareholder's basis in the loan. The corporation repaid the loan. The IRS ruled that the note was a capital asset in the hands of the taxpayer, and amounts received to retire the note were amounts received in exchange for a capital asset. The taxpayer had gain from the sale or exchange of a capital asset to the extent that the repayment exceeded his basis in the note. Each payment in retirement of the note must be allocated in part to a return of the taxpayer's basis and in part to the receipt of income. Interest payments are ordinary income.

Ordinary Income

If there is no note (e.g., open account receivable), the gain on a loan repayment with a reduced basis is ordinary income. In Rev. Rul. 68-537, 1968-2 C.B. 372, a shareholder made a loan to an electing small business corporation on an open account. The shareholder's basis in the loan was reduced by the corporation's operating losses. The IRS ruled that the income on repayment of the loan was ordinary income because there was no note to evidence the indebtedness.

Example 11.6 Repayment of Reduced Basis Shareholder Debt

The facts are the same as in Example 11.5, except that in 2023 the corporation repaid \$25,000 of the loan from George when the basis of the note is \$10,000. If George receives payment for 50% (\$25,000 repayment ÷ \$50,000 loan balance) of the loan balance, he can allocate 50% of his basis to the payment. George's gain is \$20,000 [$\$25,000 - (\$10,000 \text{ debt basis} \times 50\%)$]. Because George held the note longer than 12 months, the gain is taxed as a long-term capital gain.

PRACTITIONER NOTE

Timing of Adjustments

Usually, restoration of basis is effective at the end of the S corporation's tax year. However, if debt (other than open account debt) is repaid during the tax year, the restoration of debt basis is treated as restored immediately before the first payment.

Open Account Debt

Part II of Form 7203 requires characterization of the debt as a formal note or as open account debt. Treas. Reg. § 1.1367-2 defines *open account debt* as shareholder advances that are not evidenced by separate written instruments and repayments on the advances, the aggregate outstanding principal of which does not exceed \$25,000 of the S corporation indebtedness to the shareholder at the end of the S corporation's tax year. Advances and repayments on open account debt are treated as a single indebtedness and are netted at the end of the S corporation's tax year to determine the amount of any net advance or net repayment. If an open account debt has a year-end balance of more than \$25,000, it will be classified as a formal note at the beginning of the next tax year and must be separately tracked.

Example 11.7 **Carry Over of Open Account Debt**

May Nolen and Isaiah Coleman are the two shareholders in City Gardens, Inc., an S corporation. At the end of the 2021 tax year, May and Isaiah both had a zero stock basis. On June 1, 2022, May advanced \$16,000 to the corporation. On August 1, 2022, Isaiah advanced \$22,000 to the corporation. Neither debt was evidenced by a written instrument. Both the \$16,000 advance and the \$22,000 advance are open account debt and remain outstanding at the end of 2022. Because neither open account debt exceeds \$25,000, both carry forward to the beginning of 2023 as open account debt [Treas. Reg. § 1.1367-2(e), Example 6].

Example 11.8 **Netting Repayment and Advance on Open Account Debt**

The facts are the same as in Example 11.7 except that on December 31, 2022, May's basis in the open account debt was reduced to \$8,000 (\$16,000 – \$8,000) due to an \$8,000 loss. On April 1, 2023, City Gardens repaid May \$4,000 of the open account indebtedness. On September 1, 2023, May loaned the corporation an additional \$1,000, which is not evidenced by a written instrument. There is no restoration of debt basis in 2023.

The \$4,000 April repayment and the \$1,000 September advance are netted to result in a net repayment of \$3,000 (\$4,000 repayment – \$1,000 loan) on May's \$16,000 open account debt carried forward from 2022. The payment is 18.75% (\$3,000 net repayment ÷ \$16,000) of the total loan amount, and May can allocate \$1,500 (\$8,000 debt basis × 18.75%) of her debt basis to the payment. May realizes \$1,500 (\$3,000 – \$1,500) income on the net repayment. Her open account debt does not exceed \$25,000, and she carries forward the remaining \$13,000 (\$16,000 – \$3,000) open account debt to the beginning of the 2024 tax year [Treas. Reg. § 1.1367-2(e), Example 7].

Example 11.9 **Shareholder Indebtedness Exceeds \$25,000**

The facts are the same as in Example 11.8. On February 1, 2024, City Gardens repays \$5,000 of the open account debt to May, and on March 1, 2024, May loans the corporation an additional \$20,000. The loan is not evidenced by a written instrument. At the beginning of the 2024 tax year, May's open account debt is \$13,000 (carried forward from 2023). The 2024 repayment and advance are netted, resulting in a \$15,000 (\$20,000 loan – \$5,000 repayment) advance. At the end of the 2024 tax year, May's open account debt is \$28,000 (\$13,000 + \$15,000). Because May's open account debt exceeds \$25,000 for a subsequent tax year, in 2025, the \$28,000 indebtedness is treated as indebtedness evidenced by a separate written instrument [Treas. Reg. § 1.1367-2(e), Example 8].

PRACTITIONER NOTE

Multiple Loans

Under the general debt basis rules, if the corporation has multiple loans from a shareholder, debt basis is first restored in indebtedness that was repaid during the year to offset any gain on the repayment. The remaining increase is allocated in proportion to the amount that the outstanding basis of each loan has been reduced and not restored. In Example 11.9, May's open account debt is treated as a separate loan in 2025, and it is subject to the general rules. If May has multiple loans to the corporation, any repayment will be allocated to all debts proportionately.

Reporting S Corporation Basis

The IRS Large Business and International (LB&I) Division began a campaign to educate S corporations and their shareholders about the need to properly calculate and document shareholder

basis in S corporation stock and to educate S corporation shareholders about losses limited by basis. The compliance campaigns target, in part, when a shareholder fails to report nondividend distributions in excess of their stock basis that are subject to taxation and S corporation losses claimed in excess of basis.

This section discusses Form 7203, S Corporation Shareholder Stock and Debt Basis Limitations. S corporation shareholders use Form 7203 to figure the potential limitations of their share of the S corporation's deductions, credits, and other items that they can deduct on their individual tax returns.

Form 7203 Filing Requirements

Basis reporting is required, and a shareholder must file Form 7203 if the shareholder's Schedule K-1 (Form 1120-S) reports any of the following:

1. A deduction for a share of an aggregate loss from the S corporation (including an aggregate loss not allowed from a prior year due to basis limitations)

2. A nondividend distribution from the S corporation
3. A disposition of stock in an S corporation (regardless of whether gain is recognized)
4. A loan repayment from an S corporation

PRACTITIONER NOTE

Dividend Distributions

Dividend distributions can occur in a company that was previously a C corporation or acquired C corporation attributes in a nontaxable transaction (i.e., a merger or reorganization). Most distributions from an S corporation are nondividend distributions.

Schedule E (Form 1040), Supplemental Income and Loss, now has a check box to indicate whether basis reporting is required. **Figure 11.5** shows Schedule E (Form 1040), line 28, box (e). **Figure 11.5** shows the 2022 form because the 2023 form was not available at the time of this publication.

FIGURE 11.5 Schedule E (Form 1040) Basis Reporting

Schedule E (Form 1040) 2022		Attachment Sequence No. 13			Page 2	
Name(s) shown on return. Do not enter name and social security number if shown on other side.					Your social security number	
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 <input type="checkbox"/> Yes <input type="checkbox"/> 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"/>	<input type="checkbox"/>
B		<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
C		<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
D		<input type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
Passive Income and Loss			Nonpassive Income and Loss			
	(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1	
A						
B						
C						
D						
29a	Totals					
b	Totals					
30	Add columns (h) and (k) of line 29a				30	
31	Add columns (g), (i), and (j) of line 29b.				31	()
32	Total partnership and S corporation income or (loss). Combine lines 30 and 31				32	

Example 11.10 Shareholder Must File Form 7203

Nora Johansson is a 25% shareholder in Northern Lights Expeditions, Inc., an S corporation. For the tax year 2023, Nora received the Schedule K-1 (Form 1120-S) shown in Figure 11.6. Figure 11.6 shows the 2022 form as the 2023 form was not available at the time of this publication.

Nora's Schedule K-1 (Form 1120-S) shows a \$25,000 ordinary business loss (box 1) and a \$50,000 distribution (box 16, code D). Nora must file Form 7203 with her individual income tax return because the Schedule K-1 (Form 1120-S) reports an ordinary business loss and distributions. Either of these transactions would have triggered this reporting requirement.

FIGURE 11.6
Nora Johansson’s Schedule K-1

Schedule K-1 (Form 1120-S) Department of the Treasury Internal Revenue Service		2022 For calendar year 2022, or tax year	<input type="checkbox"/> Final K-1	<input type="checkbox"/> Amended K-1	671121 OMB No. 1545-0123
			Part III Shareholder’s Share of Current Year Income, Deductions, Credits, and Other Items		

beginning / / 2022 ending / /

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

Part I Information About the Corporation			
A Corporation’s employer identification number XX-XXXXXXX			
B Corporation’s name, address, city, state, and ZIP code Northern Lights Expeditions, Inc. 128 Glimmering Lane Grand Marais, MN 55604	5a Ordinary dividends		
C IRS Center where corporation filed return Ogden, UT	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 100 End of tax year 100	6 Royalties	15	Alternative minimum tax (AMT) items
	7 Net short-term capital gain (loss)		
	8a Net long-term capital gain (loss)		
	8b Collectibles (28%) gain (loss)		
	8c Unrecaptured section 1250 gain		
Part II Information About the Shareholder			
E Shareholder’s identifying number XXX-XX-XXXX	9 Net section 1231 gain (loss)	16	Items affecting shareholder basis
F Shareholder’s name, address, city, state, and ZIP code Nora Johansson 25 Moonlit Terrace Maple Hill, MN 55604	10 Other income (loss)	D	50,000
G Current year allocation percentage 25 %	11 Section 179 deduction		
H Shareholder’s number of shares Beginning of tax year 25 End of tax year 25	12 Other deductions		
I Loans from shareholder Beginning of tax year \$ End of tax year \$	17 Other information		
For IRS Use Only	* See attached statement for additional information.		

Completing Form 7203

Form 7203 is divided into the following three parts:

1. Part I, Shareholder Stock Basis
2. Part II, Shareholder Debt Basis
3. Part III, Shareholder Allowable Loss and Deduction Items

A shareholder must complete a separate Form 7203 for each Schedule K-1 (Form 1120-S) that the shareholder receives. Additionally, when a shareholder has a different basis in different blocks of stock, pass-through items are generally allocated pro rata to all shares, regardless of their different bases. If there is a partial stock sale or partial redemption, the taxpayer may have to file more than one form and provide a description of what period the form covers.

Example 11.11 **Completing Form 7203—** **Loss Is Not Limited**

The facts are the same as in Example 11.10. Nora's stock basis was \$90,000 at the beginning of the 2023 tax year. Nora's adjusted basis in her S corporation shares after distributions is \$40,000 ($\$90,000 - \$50,000$), and the \$25,000 loss is not limited by remaining stock basis. The loss reduces her basis to \$15,000 ($\$40,000 - 25,000$). Nora's Form 7203 is shown in **Figure 11.7**. Figure 11.7 shows the 2022 form as the 2023 form was not available at the time of this publication.

FIGURE 11.7.
Nora Johansson's Form 7203—Loss Is Not Limited

Form 7203 (Rev. December 2022) 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. 1545-2302 Attachment Sequence No. 203		
Name of shareholder Nora Johansson		Identifying number XXX-XX-XXXX		
A Name of S corporation Northern Lights Expeditions, Inc.		B Employer identification number XX-XXXXXXX		
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	90,000		
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			
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			
l Recapture of business credits	3l			
m Other items that increase stock basis	3m			
4 Add lines 3a through 3m	4	0		
5 Stock basis before distributions. Add lines 1, 2, and 4	5	90,000		
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	40,000		
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	0		
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	40,000		
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	15,000		
Part II Shareholder Debt Basis				
Section A—Amount of Debt (If more than three debts, see instructions.)				
Description	(a) Debt 1 <input type="checkbox"/> Formal note <input type="checkbox"/> Open account	(b) Debt 2 <input type="checkbox"/> Formal note <input type="checkbox"/> Open account	(c) Debt 3 <input type="checkbox"/> Formal note <input type="checkbox"/> Open account	(d) Total
16 Loan balance at the beginning of the corporation's tax year				
17 Additional loans (see instructions)				
18 Loan balance before repayment. Add 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. Subtract line 19 from line 18				

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				
23 Debt basis restoration (see instructions)				
24 Debt basis before repayment. Add 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	(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					
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	25,000		25,000		

CROSS-REFERENCE

Other Loss Limitations

A taxpayer's loss may be limited by other loss limitations, such as the at-risk rules and the passive activity loss limitations. See pages 85–107 in the *2017 National Income Tax Workbook* for a discussion of these other loss limitations.

Example 11.12 Completing Form 7203— Loss Is Limited

Ola Torgersen is also a 25% shareholder in Northern Lights Expeditions, Inc. Her Schedule K-1 information is the same as Nora's in Example 11.11. Ola's stock basis at the beginning of the 2023 tax year was \$60,000. The \$50,000 distribution reduces her stock basis to \$10,000 (\$60,000 – \$50,000) and then limits her deduction of the \$25,000 loss to her \$10,000 of remaining basis. The allowable loss reduces her stock basis to zero (line 15). Ola carries over the \$15,000 (\$25,000 – \$10,000) disallowed loss [line 47(e)] until she has basis in the stock. Ola's Form 7203 is shown in **Figure 11.8**. Figure 11.8 shows the 2022 form as the 2023 form was not available at the time of this publication.

FIGURE 11.8
Ola Torgersen's Form 7203—Loss Is Limited

<p>Form 7203 (Rev. December 2022) Department of the Treasury Internal Revenue Service</p>	<p>S Corporation Shareholder Stock and Debt Basis Limitations</p> <p>Attach to your tax return. Go to www.irs.gov/Form7203 for instructions and the latest information.</p>	<p>OMB No. 1545-2302</p> <p>Attachment Sequence No. 203</p>		
Name of shareholder Ola Torgersen		Identifying number XXX-XX-XXXX		
A Name of S corporation Northern Lights Expeditions, Inc.		B Employer identification number XX-XXXXXXX		
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	60,000		
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			
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			
l Recapture of business credits	3l			
m Other items that increase stock basis	3m			
4 Add lines 3a through 3m	4	0		
5 Stock basis before distributions. Add lines 1, 2, and 4	5	60,000		
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	10,000		
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	0		
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	10,000		
11 Allowable loss and deduction items. Enter the amount from line 47, column (c)	11	10,000		
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	10,000		
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	0		
Part II Shareholder Debt Basis				
Section A—Amount of Debt (If more than three debts, see instructions.)				
Description	(a) Debt 1 <input type="checkbox"/> Formal note <input type="checkbox"/> Open account	(b) Debt 2 <input type="checkbox"/> Formal note <input type="checkbox"/> Open account	(c) Debt 3 <input type="checkbox"/> Formal note <input type="checkbox"/> Open account	(d) Total
16 Loan balance at the beginning of the corporation's tax year				
17 Additional loans (see instructions)				
18 Loan balance before repayment. Add 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. Subtract line 19 from line 18				

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				
23 Debt basis restoration (see instructions)				
24 Debt basis before repayment. Add 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	(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		10,000		15,000
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 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	25,000		10,000		15,000

**Example 11.13
Completing Form 7203—
Loss Is Allowed by Debt Basis**

The facts are the same as in Example 11.12 except that in 2023, Ola loaned the S corporation \$40,000 pursuant to a promissory note. The loan is an interest only loan that matures in 5 years.

Ola's \$10,000 remaining stock offsets \$10,000 of her loss and reduces her stock basis to zero. Ola's

\$40,000 debt basis offsets the remaining \$15,000 (\$25,000 – \$10,000) of her loss, which reduces her debt basis to \$25,000 (\$40,000 – \$15,000). Ola's loss is not limited by basis.

Figure 11.9 shows Ola's Form 7203. Part II, box (a), indicates that the debt is evidenced by a formal note. Figure 11.9 shows the 2022 form as the 2023 form was not available at the time of this publication.

FIGURE 11.9
Ola Torgersen's Form 7203—Loss Is Allowed by Debt Basis

Form 7203 (Rev. December 2022) 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. 1545-2302 Attachment Sequence No. 203		
Name of shareholder Ola Torgersen		Identifying number XXX-XX-XXXX		
A Name of S corporation Northern Lights Expeditions, Inc.		B Employer identification number XX-XXXXXXX		
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	60,000		
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			
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			
l Recapture of business credits	3l			
m Other items that increase stock basis	3m			
4 Add lines 3a through 3m	4	0		
5 Stock basis before distributions. Add lines 1, 2, and 4	5	60,000		
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	10,000		
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	0		
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	10,000		
11 Allowable loss and deduction items. Enter the amount from line 47, column (c)	11	10,000		
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	10,000		
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	0		
Part II Shareholder Debt Basis				
Section A—Amount of Debt (If more than three debts, see instructions.)				
Description	(a) Debt 1 <input checked="" type="checkbox"/> Formal note <input type="checkbox"/> Open account	(b) Debt 2 <input type="checkbox"/> Formal note <input type="checkbox"/> Open account	(c) Debt 3 <input type="checkbox"/> Formal note <input type="checkbox"/> Open account	(d) Total
16 Loan balance at the beginning of the corporation's tax year	40,000			40,000
17 Additional loans (see instructions)				
18 Loan balance before repayment. Add lines 16 and 17	40,000			40,000
19 Principal portion of debt repayment (this line doesn't include interest)	0			0
20 Loan balance at the end of the corporation's tax year. Subtract line 19 from line 18	40,000			40,000

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	40,000			40,000
22 Enter the amount, if any, from line 17				
23 Debt basis restoration (see instructions)				
24 Debt basis before repayment. Add lines 21, 22, and 23	40,000			40,000
25 Divide line 24 by line 18	1			
26 Nontaxable debt repayment. Multiply line 25 by line 19				1
27 Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24	40,000			40,000
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-	40,000			40,000
30 Allowable losses in excess of stock basis. Enter the amount from line 47, column (d)	15,000			15,000
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-	25,000			25,000

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	25,000		10,000	15,000	
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 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	25,000		10,000	15,000	

**Example 11.14
Completing Form 7203,
Restoration of Debt Basis**

The facts are the same as in Example 11.13. The S corporation reports \$150,000 income to Ola in 2024 and makes a \$60,000 distribution to her. The income first offsets the distribution and then restores Ola's debt basis from \$25,000 to the

original \$40,000 face value (page 2, Part II). The remaining income then increases Ola's stock basis to \$75,000 (\$150,000 income – \$60,000 distribution – \$15,000 stock basis) (Part I, line 15). **Figure 11.10** shows Ola's 2024 Form 7203. **Figure 11.10** shows the 2022 form as the 2024 form was not available at the time of this publication.

FIGURE 11.10
Ola Torgersen's 2024 Form 7203, Restoration of Debt Basis

Form 7203 (Rev. December 2022) 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. 1545-2302 Attachment Sequence No. 203		
Name of shareholder Ola Torgersen		Identifying number XXX-XX-XXXX		
A Name of S corporation Northern Lights Expeditions, Inc.		B Employer identification number XX-XXXXXXX		
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	
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	
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		
3e	Ordinary dividends	3e		
3f	Royalties	3f		
3g	Net capital gains (enter losses in Part III)	3g		
3h	Net section 1231 gain (enter losses in Part III)	3h		
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	150,000	
5	Stock basis before distributions. Add lines 1, 2, and 4	5	150,000	
6	Distributions (excluding dividend distributions)	6	60,000	
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	90,000	
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	0	
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	90,000	
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	15,000	
13	Other items that decrease stock basis	13		
14	Add lines 11, 12, and 13	14	15,000	
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	75,000	
Part II Shareholder Debt Basis				
Section A—Amount of Debt (If more than three debts, see instructions.)				
Description	(a) Debt 1 <input checked="" type="checkbox"/> Formal note <input type="checkbox"/> Open account	(b) Debt 2 <input type="checkbox"/> Formal note <input type="checkbox"/> Open account	(c) Debt 3 <input type="checkbox"/> Formal note <input type="checkbox"/> Open account	(d) Total
16 Loan balance at the beginning of the corporation's tax year	40,000			40,000
17 Additional loans (see instructions)				
18 Loan balance before repayment. Add lines 16 and 17	40,000			40,000
19 Principal portion of debt repayment (this line doesn't include interest)	0			
20 Loan balance at the end of the corporation's tax year. Subtract line 19 from line 18	40,000			40,000

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	25,000			25,000
22 Enter the amount, if any, from line 17				
23 Debt basis restoration (see instructions)	15,000			15,000
24 Debt basis before repayment. Add lines 21, 22, and 23	40,000			40,000
25 Divide line 24 by line 18	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	40,000			40,000
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-	40,000			40,000
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-	40,000			40,000

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					

**Example 11.15
Principal Payment on
Reduced Basis Loan**

The facts are the same as in Example 11.14 except that in 2024 the corporation has no taxable income or loss and makes no distributions to Olga. The corporation obtains commercial financing and pays off \$30,000 of Ola's \$40,000 note.

Ola's beginning stock basis is zero and her beginning debt basis is \$25,000. There are no adjustments to stock basis on Form 7203, Part I. Part II, Section A, reports the recomputed loan balance on line 20. Ola allocates \$18,750 [(\$25,000 beginning debt basis ÷ \$40,000 note) × \$30,000 repayment] to the principal paid. Part II, Section B, shows this allocation of debt basis to the principal paid (line 26), and the remaining

\$6,250 (\$25,000 beginning debt basis – \$18,750 principal paid) basis (line 31) for the \$10,000 outstanding loan balance. Finally, Part II, Section C, computes the \$11,250 (\$30,000 repayment – \$18,750 principal paid) gain (line 34) that Ola must report on the repayment. Ola reports this gain on Form 8949, Sales and Other Dispositions of Capital Assets, and Schedule D (Form 1040),

Capital Gains and Losses, as a long-term capital gain because the loan is evidenced by a formal note and was held more than 12 months.

Figure 11.11 shows Ola’s 2024 Form 7203. Figure 11.11 shows the 2022 form as the 2024 form was not available at the time of this publication.

FIGURE 11.11
Ola Torgersen’s 2024 Form 7203, Gain on Loan Repayment

Form 7203 (Rev. December 2022) 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. 1545-2302 Attachment Sequence No. 203	
Name of shareholder Ola Torgersen				Identifying number XXX-XX-XXXX	
A Name of S corporation Northern Lights Expeditions, Inc.				B Employer identification number XX-XXXXXXX	
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	
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	
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	
l Recapture of business credits				3l	
m Other items that increase stock basis				3m	
4 Add lines 3a through 3m				4	
5 Stock basis before distributions. Add lines 1, 2, and 4				5	
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	
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	
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	

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 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	40,000			40,000
17 Additional loans (see instructions)				
18 Loan balance before repayment. Add lines 16 and 17	40,000			40,000
19 Principal portion of debt repayment (this line doesn't include interest)	30,000			30,000
20 Loan balance at the end of the corporation's tax year. Subtract line 19 from line 18	10,000			10,000

For Paperwork Reduction Act Notice, see separate instructions.

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Form **7203** (Rev. 12-2022)

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	25,000			25,000
22 Enter the amount, if any, from line 17				
23 Debt basis restoration (see instructions)				
24 Debt basis before repayment. Add lines 21, 22, and 23	25,000			25,000
25 Divide line 24 by line 18	0.625			
26 Nontaxable debt repayment. Multiply line 25 by line 19	18,750			18,750
27 Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24	6,250			6,250
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-	6,250			6,250
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-	6,250			6,250

Section C—Gain on Loan Repayment

32 Repayment. Enter the amount from line 19	30,000			30,000
33 Nontaxable repayments. Enter the amount from line 26	18,750			18,750
34 Reportable gain. Subtract line 33 from line 32	11,250			11,250

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					

ISSUE 3: FIXING S CORPORATION ELIGIBILITY ERRORS

This section discusses new procedures to facilitate the correction of S corporation eligibility errors.

Rev. Proc. 2022-19, 2022-41 I.R.B. 282, provides procedures that allow S corporations and their shareholders to resolve frequently encountered eligibility issues, without requesting a private letter ruling (PLR). This revenue procedure provides relief from inadvertent invalid S elections or terminations. This revenue procedure is intended to minimize the burden on taxpayers seeking relief and to facilitate increased taxpayer compliance with S election and qualified subchapter S subsidiary (QSub) election requirements.

S Corporation Eligibility

I.R.C. § 1361 defines an S corporation as a small business corporation for which an S election, under I.R.C. § 1362(a), is in effect for that year. Section 1361(b)(1) defines a small business corporation as a domestic corporation that is not an ineligible corporation and that does not have

1. more than 100 shareholders,
2. a shareholder [other than an estate, a trust described in section 1361(c)(2), or an organization described in section 1361(c)(6)] who is not an individual,
3. a nonresident alien shareholder, and
4. more than 1 class of stock.

Section 1361(b)(3)(B) defines a QSub as a domestic corporation that is not an ineligible corporation if an S corporation (parent S corporation) holds 100% of the stock of the corporation, and that parent S corporation elects to treat the subsidiary as a QSub.

CROSS-REFERENCE

Eligible Shareholders

Decedent and bankruptcy estates, and certain trusts, tax-exempt entities, and qualified plans may be eligible S corporation shareholders. For a discussion of the entities that are permissible S corporation shareholders, see pages 104–106 in the *2020 National Income Tax Workbook*.

S and QSub Elections

Treas. Reg. § 1.1362-6(a)(2) sets forth procedural requirements pursuant to which a small business corporation makes an S election. Among those requirements, the small business corporation must timely file a completed Form 2553, Election by a Small Business Corporation. Form 2553 is due by the fifteenth day of the third month of the tax year for which the election is to take effect.

Treas. Reg. § 1.1361-3(a) and Notice 2000-58, 2000-2 C.B. 491, set forth procedural requirements for a parent S corporation to elect to treat one or more of its eligible subsidiaries as a QSub. Among those requirements, the parent S corporation must timely file a completed Form 8869, Qualified Subchapter S Subsidiary Election. Rev. Proc. 2013-30, 2013-36 I.R.B. 173, provides a simplified method for taxpayers to request relief for late S and QSub elections.

Ineffective or Terminated S or QSub Election

If a corporation is not eligible to elect to be taxed under subchapter S [for example, the corporation is not a small business corporation under section 1361(b)(1)], then the corporation's S election never becomes effective. Once a corporation makes a valid S election, generally its status as an

S corporation can be terminated by revocation of the election. The S corporation status will be terminated if the corporation ceases to be a small business corporation, or if the passive investment income of the corporation exceeds 25% of gross receipts for 3 consecutive tax years and the corporation has accumulated earnings and profits at the end of each of the 3 consecutive years.

If a parent S corporation cannot make an effective QSub election because the subsidiary corporation is not eligible to be taxed as a QSub (for example, the required consent on Form 8869 is missing), then that corporation's QSub election never becomes effective. If a parent S corporation makes a valid QSub election for its subsidiary, generally the subsidiary's status as a QSub can be terminated by revocation of the election. The QSub status is terminated if the S election of its parent S corporation is terminated, or the subsidiary ceases to qualify as a QSub. In addition, a QSub election for a subsidiary terminates if the parent S corporation transfers 100% of the QSub stock, whether by sale or reorganization, to another S corporation in a transaction that does not qualify as a reorganization under I.R.C. § 368(a)(1)(F) [Rev. Rul. 2004-85, 2004-2 C.B. 189 (Situation 2)].

Relief for Inadvertent or Invalid Elections

Section 1362(f) provides relief from certain defective elections and inadvertent terminations. The IRS must determine that the circumstances resulting in the ineffectiveness or termination were inadvertent. Within a reasonable time after discovery of the circumstances resulting in that ineffectiveness or termination, the taxpayer must take steps to correct the error. The corporation for which the election was made or the termination occurred, and each person who was a shareholder in that corporation, must agree to make such adjustments consistent with the treatment of that corporation as an S corporation or a QSub. A corporation may request invalid election or inadvertent termination relief by submitting a PLR request.

Rev. Proc. 2022-19 Taxpayer Assistance Procedures

Rev. Proc. 2022-19 describes the six areas for which issues are resolvable without a PLR and provides taxpayer assistance procedures for the following:

1. One class of stock requirement and governing provisions, including principal purpose conditions
2. Disproportionate distributions
3. Certain inadvertent errors or omissions on Form 2553, Election by a Small Business Corporation, or Form 8869, Qualified Subchapter S Subsidiary Election
4. Missing administrative acceptance letter for S election or QSub election
5. A federal income tax return filing inconsistent with an S election or QSub election
6. Nonidentical governing provisions

One Class of Stock Requirement

A corporation that has more than one class of stock does not qualify as a small business corporation. A corporation is treated as having only one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds.

The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (the governing provisions). Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements do not create more than one class of stock unless a principal purpose of the agreement is to circumvent the one class of stock requirement, or the agreement otherwise alters the shareholders' rights to distribution and liquidation proceeds. Rev. Proc. 2022-19 provides that the IRS will not treat taxpayers who have entered into these

agreements or arrangements as violating the one class of stock requirement if there was no principal purpose to use the agreement or arrangement as a means to circumvent the one class of stock requirement. Because entering into these specific agreements in these circumstances will not result in termination of S corporation status, taxpayers do not need to seek relief from the IRS.

Example 11.16 **Buy-Sell Agreement**

Jane Spritzer sold 50% of her S corporation shares to her employee, Jeff Weinberg. Jane and Jeff entered into a buy-sell agreement that gives them each the option to purchase the shares of a deceased shareholder. The agreement is to preserve the continuity of business ownership, and not to circumvent the one class of stock requirement. Jane and Jeff have not violated the one class of stock requirement, and they do not need to seek relief from the IRS.

Disproportionate Distributions

A disproportionate distribution is any distribution (including an actual distribution, a constructive distribution, or a deemed distribution) of property by a corporation with respect to shares of its stock that differs in timing or amount from the distribution with respect to any other shares of its stock. If the governing provisions provide for identical distribution and liquidation rights but makes disproportionate distributions, there could be a violation of the one class of stock requirement. However, Rev. Proc. 2022-19 provides that the IRS will not treat any disproportionate distributions by a corporation as violating the one class of stock requirement if the corporation's governing provisions provide for identical distribution and liquidation rights. Because disproportionate distributions made in these circumstances will not result in the termination of S corporation status, taxpayers do not need to seek relief from the IRS.

Inadvertent Errors or Omissions

An inadvertent error or omission on Form 2553 or Form 8869 will invalidate an S election or a QSub election if the error or omission is with respect to a shareholder consent, a selection of a permitted year, or an officer's signature. An S election is valid only if all persons who are shareholders in the corporation on the day on which such election is made consent to such election. The S corporation's tax year must be a permitted year, which includes a calendar year or any other tax year for which the corporation establishes a business purpose. A QSub election form must be signed by a person authorized to sign the S corporation's return. Rev. Proc. 2022-19 provides procedures for a taxpayer to correct, without the receipt of a PLR, an error, an omission, a missing required consent on a Form 2553 or Form 8869, and other inadvertent errors.

Missing Shareholder Consent

An S election that fails to include the consent of a shareholder may be corrected pursuant to the following:

1. Treas. Reg. § 1.1362-6(b)(3)(iii), extension of time for filing a shareholder consent to an S election
2. Rev. Proc. 2013-30, simplified method for taxpayers to request relief for late S elections
3. Rev. Proc. 2004-35, 2004-1 C.B. 1029, automatic relief for certain taxpayers requesting relief for late shareholder consents for S elections in community property states
4. PLR request for other relief

Permitted-Year Errors

A Form 2553 that contains an inadvertent error with regard to a permitted year may be corrected pursuant to Rev. Proc. 2013-30 (simplified method for taxpayers to request relief for late S elections). If a taxpayer is not eligible for relief under Rev. Proc. 2013-30, a correction may be obtained through the receipt of a PLR.

Missing Officer's Signature

Form 2553 or Form 8869 that is missing the signature of an authorized officer of the S corporation that affects the validity of the S election or QSub election may be corrected pursuant to Rev. Proc. 2013-30. If a taxpayer is not eligible for relief under Rev. Proc. 2013-30, a correction may be obtained through the receipt of a PLR.

Other Inadvertent Errors or Omissions

Other errors and omissions on Form 2553 or Form 8869 may be corrected by explaining in writing the error(s) or omission(s) and the necessary correction(s) and submitting the written explanation to one of the following addresses (depending on the Internal Revenue Submission Processing Center with which the S corporation files its Form 1120-S) or any successor address the IRS may provide:

- Internal Revenue Service, MS 6055, 333 W. Pershing Rd., Kansas City, MO 64108
- Internal Revenue Service, MS 6273, 1973 N. Rulon White Blvd., Ogden, UT 84404

Missing Administrative Acceptance Letter

Generally, within 90 days after the IRS receives a corporation's Form 2553, the IRS mails a CP261 Notice as an acknowledgment to the corporation that the IRS has accepted the corporation's filing. For QSub elections filed on Form 8869, the IRS mails a CP279 Notice to the filer and a CP279A Notice to the subsidiary, generally within 60 days after the IRS accepts the Qsub election.

A lack of written acknowledgment that the IRS has accepted the corporation's S election or its subsidiary's Qsub election (for example, because it was lost or never received) creates uncertainty for some taxpayers about the validity of the election, but does not affect the validity of the election.

Rev. Proc. 2022-19 provide procedures to replace a missing CP261 Notice, CP279 Notice, or CP279A Notice. The taxpayer or tax practitioner can request a replacement letter as follows:

1. An S corporation and shareholders of an S corporation can contact the IRS Business and Specialty Tax Line at 800.829.4933.
2. Tax practitioners can contact the IRS Practitioner Priority Service at 866.860.4259.

Inconsistent Federal Income Tax Filing

Occasionally, a corporation files a federal income tax return that is inconsistent with the corporation's status as an S corporation or a QSub (for example, an S corporation files a Form 1065, U.S. Return of Partnership Income, or Form 1120, U.S. Corporation Income Tax Return, instead of Form 1120-S, U.S. Income Tax Return for an S Corporation). The filing does not affect the validity of a corporation's S election or QSub election.

Rev. Proc. 2022-19 provides procedures for taxpayers to address, without the receipt of a PLR, a federal income tax return filing that is inconsistent with an S election or a QSub election. The S corporation must file the correct return for open tax years. An inconsistent return filing does not affect S corporation status, and the IRS will not issue a PLR. The corporation's distributions and other transactions will be treated consistent with its status as an S corporation or a QSub.

Nonidentical Governing Provisions

An S corporation has only one class of stock if all outstanding shares of the corporation's stock confer identical rights to distribution and liquidation proceeds and if the corporation has not issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock. An S corporation in compliance with these requirements has *identical governing provisions*. The term *nonidentical governing provision* means a governing provision that results in the S corporation having more than one class of stock (even if the S corporation never made a non-pro rata distribution or liquidating distribution).

Nonidentical governing provisions may result in an invalid S corporation election or termination of the S corporation election. Rev. Proc. 2022-19 provides procedures for correcting, without the receipt of a PLR, the validity or continuation of an S election with regard to one or more nonidentical governing provisions.

An eligible S corporation and its applicable shareholders can retroactively disregard an S election that was invalid or terminated because of nonidentical governing provisions. An *applicable shareholder* means a current or former shareholder of a corporation who owns or owned stock of the corporation beginning on the date on which the nonidentical governing provision was adopted (on its own or as part of another governing provision); and ending on the date on which the nonidentical governing provision was removed or corrected.

A small business corporation and each applicable shareholder are eligible for this corrective relief if the following requirements are satisfied:

1. The corporation has or had one or more nonidentical governing provisions.

2. The corporation has not made, and for federal income tax purposes is not deemed to have made, a disproportionate distribution to an applicable shareholder.
3. The corporation timely filed a return on Form 1120-S for each tax year of the corporation beginning with the tax year in which the first nonidentical governing provision was adopted and through the tax year immediately preceding the tax year in which the corporation made a request for corrective relief.
4. Before the IRS discovers the nonidentical governing provision, the corporation completes a Corporate Governing Provision Statement and a Shareholder Statement for each applicable shareholder [see Rev. Proc. 2022-19 § 3.06(2)(c) for the contents of the statements, and Appendices A and B for sample statements]. **Figure 11.12** shows the required representations in the Corporate Governing Provision Statement.

FIGURE 11.12 Required Representations

Section 4. Required Representations or Explanation of the Corporation

1. Except as provided by Section 5 of this Corporate Governing Provision Statement, provide the following representations required by section 3.06(2)(c)(ii)(C) and (D) of Rev. Proc. 2022-19:
 - A. The Corporation's S election was inadvertently invalid or terminated solely because of the adoption of one or more non-identical governing provisions.
 - B. The Corporation and each applicable shareholder satisfy all of the requirements set forth in section 3.06 of Rev. Proc. 2022-19.
 - C. Except as provided by section 4.2 of this Corporate Governing Provision Statement, the Corporation responds in the negative to each requested statement set forth in section 7.01(4) or (5) of Rev. Proc. 2022-1, 2022-1 I.R.B. 1, or any successor revenue procedure (statements regarding whether the same or a similar issue was previously ruled on or whether a request involving the same or a similar issue was submitted or is currently pending).
 - D. The corporation and each applicable shareholder acted reasonably and in good faith in correcting or removing each non-identical governing provision upon discovery.
2. Required Explanation. If the Corporation has a positive response to any requested statement set forth in section 7.01(4) or (5) of Rev. Proc. 2022-1 (or any successor revenue procedure), the Corporation must provide an explanation for each such response as part of the description of all relevant facts required by section 3.06(2)(c)(ii)(B)(4) of Rev. Proc. 2022-19.

Example 11.17

Nonidentical Governing Provision

Busy Birds, LLC was organized as a limited liability company in 2021. In January 2022, the company's accountant recommended that the company make an S election. The company filed Form 2553 to make this election. In early 2023, the company attorney noticed that the company's operating agreement provides for liquidating distributions in accordance with capital account balances, and then according to percentage interest in the company. The liquidation provision is a nonidentical governing provision.

The corporation has not made disproportionate distributions, it timely files its Form 1120-S, and the IRS has not discovered the nonidentical governing provision. The corporation corrects the error so that each shareholder's liquidating distribution is based on the number of shares owned. If the corporation completes a Corporate Governing Provision Statement and a Shareholder Statement for each shareholder, the correction and validity of its S corporation status is retroactive.

PRACTITIONER NOTE

AICPA Recommendations

On April 5, 2023, the American Institute for Certified Public Accountants (AICPA) gave the IRS recommendations to clarify Rev. Proc. 2022-19. The AICPA asked the IRS to provide that only disproportionate distributions made pursuant to nonidentical governing provisions disqualify the entity from relief. The AICPA asked the IRS to provide factors that determine when an arrangement relating to distributions will constitute a governing provision and to provide examples of arrangements that have and have not been determined to constitute a governing provision under applicable law.

PRACTITIONER NOTE

Letter Rulings

Rev. Proc. 2023-1, 2023-1 I.R.B. 1, contains revised procedures for letter rulings and information letters. It updates the list of issues on which the IRS will issue a PLR. Rev. Proc. 2023-3, 2023-1 I.R.B. 144, provides a revised list of areas of the code relating to matters on which the IRS will not issue a PLR or determination letter.

ISSUE 4: I.R.C. § 501(C)(6) BUSINESS LEAGUES Business leagues, chambers of commerce, and certain other organizations may be eligible for tax-exempt status under I.R.C. § 501(c)(6).

I.R.C. § 501(c)(6) provides tax-exempt status for business leagues, chambers of commerce, real estate boards, boards of trade, and professional football leagues. The organization must not be organized for profit, and no part of the net earnings can inure to the benefit of any private shareholder or individual. These organizations are commonly trade associations or professional associations.

As of fiscal year 2022, the IRS reports that there were 60,580 business leagues recognized as tax-exempt under section 501(c)(6) [*IRS Data Book 2022*]. These organizations can engage in a wide range of activities to promote and improve their industry or profession, including lobbying, networking, education, and research.

A tax practitioner may be asked to help determine a new organization's eligibility under section 501(c)(6) or to advise an existing organization about its ongoing activities and tax-filing obligations. The practitioner must be able to recognize when an organization meets the requirements for section 501(c)(6) tax-exempt status and the requirements to maintain that status. This section defines a business league, explains its eligibility for tax-exempt status, and reviews its tax-filing obligations. This section also explains how a tax practitioner can help a section 501(c)(6) organization apply for reinstatement after its tax-exempt status was revoked for failure to file its annual returns.

Business Leagues

Treas. Reg. § 1.501(c)(6)-1 defines a business league as an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or

board of trade. Therefore, its activities should be directed to the improvement of business conditions of one or more lines of business, as distinguished from the performance of particular services for individual persons.

An organization whose purpose is to engage in a regular business of a kind ordinarily conducted for profit, even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league. An association engaged in furnishing information to prospective investors, to enable them to make sound investments, is also not a business league, because its activities do not further any common business interest, even though all its income is devoted to the stated purpose. A stock or commodity exchange is not a business league, a chamber of commerce, or a board of trade within the meaning of section 501(c)(6) and is not exempt from tax.

PRACTITIONER NOTE

Formation and Application Process

A section 501(c)(6) organization is typically a state nonprofit corporation, with members. Its formation documents must be consistent with its tax-exempt purpose and establish membership eligibility criteria. The organization applies for federal tax-exempt status on Form 1024, Application for Recognition of Exemption Under Section 501(a) or Section 521 of the Internal Revenue Code, which must include Schedule C, Organizations described in section 501(c)(6) – Business leagues, chambers of commerce, etc. Form 1024 is filed electronically on pay.gov. Generally, if Form 1024 is filed within 27 months after the month in which the organization is legally formed, the effective date of recognition of tax-exempt status will be the legal date of formation.

Eligibility for Tax-Exempt Status

To be eligible for section 501(c)(6) tax-exempt status, an organization must meet all the following requirements:

1. It must be an association of persons having a common business interest, and its purpose must be to promote this common business interest.
2. It must be a membership organization and have a meaningful extent of membership support.
3. It must not be organized for profit.
4. No part of its net earnings may inure to the benefit of any private shareholder or individual.
5. Its activities must be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons.
6. Its primary activity cannot consist of performing particular services for individual persons.
7. Its purpose must not be to engage in a regular business of a kind ordinarily carried on for profit, even if the business is operated on a cooperative basis or produces only sufficient income to be self-sustaining.

Each of these characteristics is interrelated, and if an organization does not meet one of the requirements, it will likely not meet at least one other requirement. The remainder of this section discusses the common business interest test, membership and support requirements, and the prohibition on private inurement.

Common Business Interest

For members of an organization to share a common business interest, the organization must serve a business purpose for its members. While the members may have diverse interests, the organization must promote a business interest that is common among the members.

The term *business* is broadly interpreted for purposes of section 501(c)(6). It includes professions and also mercantile and trading businesses [Rev. Rul. 70-641, 1970-2 C.B. 119].

Qualifying Organizations

The following types of organizations have been found to promote a common business interest:

- A medical specialty board that devises and administers written examinations to physicians in a particular medical specialty and issues certificates to successful candidates promotes the common business interests of physicians. Listings of the certified physicians are made available by the board to various medical groups who in turn make the listings available to the public [Rev. Rul. 73-567, 1973-2 C.B. 178].
- A nonprofit organization formed by members of a state medical association to operate peer review boards for the primary purpose of establishing and maintaining standards for quality, quantity, and reasonableness of costs of medical services furthers the common business purpose of its members. The organization strives to maintain professional standards within the medical profession [Rev. Rul. 74-553, 1974-2 C.B. 168].
- An organization composed of persons studying for a degree in a particular profession may be an association of persons having a common business interest even though the students are not presently engaged in a business. The purpose of the organization is to promote their common interests as future members of that profession [Rev. Rul. 77-112, 1977-1 C.B. 149].
- An organization is composed of business persons and its activities are limited to holding luncheon meetings devoted to a discussion, review, and consideration of the various problems in a particular industry. The meetings are directed to the improvement of business conditions as a whole, and the members have a common business purpose [Rev. Rul. 67-295, 1967-2 C.B. 197].

- An organization of business and professional women that promotes the acceptance of women in business and the professions qualifies as a business league. By sponsoring events devoted to the discussion and consideration of problems affecting women in business and the professions, the organization is promoting a common business interest [Rev. Rul. 76-400, 1976-2 C.B. 153].
- An organization formed to promote the commercial fishing industry in a particular state through the publication and dissemination of a newspaper that contains news of events of interest to the fishermen and new techniques and advances in the commercial fishing industry qualifies for section 501(c)(6) status [Rev. Rul. 75-287, 1975-2 C.B. 211].

Nonqualifying Organizations

Organizational activities that do not promote a common business purpose include the following:

- A national association of individual auto owners and affiliated auto clubs did not qualify as a business league because the association's principal activities consisted of securing benefits and performing particular services for members [*American Automobile Association v. Commissioner*, 19 T.C. 1146 (1953)].
- An organization that promoted the common interests of hobbyists did not qualify under section 501(c)(6) because its members were primarily interested in sport and not in business [*American Kennel Club v. Hoey*, 142 F.2d 920 (2nd Cir. 1945)].

Membership and Support

To be eligible for section 501(c)(6) tax-exempt status, an organization must be a membership organization and have a meaningful extent of membership support.

Defining Membership

A section 501(c)(6) organization must define and enforce membership eligibility criteria. Membership must be limited to individuals and businesses that share a common business interest or purpose. This means that the organization must have clearly defined criteria for membership that is based on the nature of the business or industry it represents. The eligibility criteria must be objective, well-documented, and consistently applied to all potential members.

Meaningful Support

A section 501(c)(6) organization's support is typically dues paid by members. The organization may receive a substantial portion or even the primary part of its income from nonmember sources. However, membership support must be at a meaningful level. For purposes of determining membership support, support includes income derived from performance of the organization's exempt functions, and public contributions and gifts. Membership support does not include unrelated business taxable income.

PRACTITIONER NOTE

Deducting Dues and Contributions

Contributions to section 501(c)(6) organizations are not deductible as charitable contributions on the donor's federal income tax return. They may be deductible as trade or business expenses if ordinary and necessary in the conduct of the taxpayer's business. Additional disclosure and tax provisions apply to section 501(c)(6) organizations with lobbying and political expenditures.

Private Inurement

No part of a section 501(c)(6) organization's net earnings can inure to the benefit of any private shareholder or individual. Inurement occurs when an individual or organization benefits from the income or assets of a tax-exempt organization, creating a private benefit rather than a public benefit.

The inurement prohibition does not preclude members from receiving benefits from the organization. For example, members of a business league may benefit from the general improvement of business conditions in their line of business. Benefits that serve the common business interest of members such as educational programs, allowable lobbying activities, and industry-wide advertising services are substantially related to the organization's exempt purpose [*Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982)]. However, inurement results from a use of organizational funds that results in a benefit that exceeds the scope of the benefits that logically flow from the organization's performance of its exempt functions [G.C.M. 38559 (November 8, 1980)].

Distributions to Members

Inurement can occur if there is a distribution of funds for the benefit of individual members. The following are examples of distributions that have found to constitute inurement:

- An organization promoted an annual trade show. It rented exhibit booths to members and nonmembers for a fee. The organization distributed a percentage of the trade show earnings to its members who rented exhibit booths. It did not make any distributions to the nonmembers who rented booths [*Michigan Mobile Home & Recreational Vehicle Institute v. Commissioner*, 66 T.C. 770 (1976)].
- A business league was formed to improve business conditions in its members' line of business. The league provided financial aid and welfare services to any member whose employment was involuntarily terminated [Rev. Rul. 67-251, 1967-2 C.B. 196].

- An organization was formed to protect and promote the chiropractic profession. Its income was from member dues and sales of a chiropractic journal. The organization paid its members for expenses they incurred in defending malpractice suits and paying judgments rendered in the suits [*National Chiropractic Association, Inc. v. Birmingham*, 96 F. Supp. 874 (N.D. Iowa 1951)].
- An association of wholesale grocers owned a copyright on certain grocery labels and paid royalties to its members [*Wholesale Grocers Exchange, Inc. v. Commissioner*, 3 T.C.M. 699 (1944)].

PRACTITIONER NOTE

Inurement Consequences

Inurement of a section 501(c)(6) organization's net earnings to a private individual will result in ineligibility for tax-exempt status, or for an existing organization, revocation of that status. The I.R.C. § 4958 excise taxes on excess benefit transactions between disqualified persons do not apply to section 501(c)(6) organizations.

Distributions from a section 501(c)(6) organization to its members do not result in inurement if they represent no more than a reduction in dues or contributions previously paid to the organization to support its activities, and the distributions are made equally to all members who paid dues or contributions.

Nonmember Income

Funds received from nonmembers that are used to provide a benefit to members may result in inurement. Nonmember income may, for example, reduce member dues, or be used to expand and enlarge activities for members. However, nonmember income does not result in inurement when the income is related to the organization's exempt purpose and benefits individual members only through the general improvement of business conditions or a line of business.

Other Inurement Issues

Inurement to the benefit of a private individual can arise if the organization pays excessive compensation to its officers or directors, or makes goods, services, or other benefits available to its members on a low-cost or no-cost basis, and not in furtherance of its exempt purpose. To avoid private inurement, a section 501(c)(6) organization sale of assets must be at arm's length and at FMV. Loans from the organization to private persons must accrue interest at a rate that is comparable to what commercial lenders charge.

PRACTITIONER NOTE

Performance of Particular Services

Performance of particular services by an organization for its members or others is not a section 501(c)(6) activity. While such activities do not preclude exemption, an organization whose primary activity is performing particular services is not exempt under section 501(c)(6). Advertising that carries the names of members generally constitutes the performance of particular services for members. Purchasing equipment and supplies, booking trips, answering phones, and doing laundry may be particular services for members.

Annual Tax Filing

Typically, a section 501(c)(6) organization must file an annual return or notice as follows:

- Form 990-N (e-Postcard): Gross receipts (defined later) are normally \$50,000 or less. An organization eligible to submit Form 990-N can instead choose to file Form 990 or Form 990-EZ to satisfy its annual reporting requirement.
- Form 990-EZ, Short Form Return of Organization Exempt From Income: Gross receipts are less than \$200,000 and total assets are less than \$500,000 at the end of

the tax year. The organization can choose to file Form 990.

- Form 990, Return of Organization Exempt From Income Tax: Gross receipts are greater than or equal to \$200,000, or total assets are greater than or equal to \$500,000 at the end of the tax year.

Form 990 is due on the fifteenth day of the fifth month after the end of the organization's fiscal year. The due date may be extended for 6 months, without showing cause, by filing Form 8868, Application for Automatic Extension of Time To File an Exempt Organization Return, before the due date. An organization is allowed only one 6-month extension for a tax year. Failure to timely file a required return may result in imposition of a penalty under I.R.C. § 6652(c).

Gross Receipts

Gross receipts are the total amounts the organization received from all sources during its annual accounting period, without subtracting any costs or expenses. Gross receipts are considered to be normally \$50,000 or less, as follows:

1. The organization has been in existence for 1 year or less and received, or donors have pledged to give, \$75,000 or less during its first tax year.
2. The organization has been in existence between 1 and 3 years and averaged \$60,000 or less in gross receipts during each of its first 2 tax years.
3. The organization is at least 3 years old and averaged \$50,000 or less in gross receipts for the immediately preceding 3 tax years (including the year for which calculations are being made).

Unrelated Business Taxable Income

Organizations otherwise exempt from tax under section 501(c)(6) are taxed on their unrelated business taxable income. For most organizations, unrelated business income is income from a trade or business, regularly carried on, that is not substantially related to the charitable, educational, or other purpose that is the basis of the organization's exemption. An exempt organization that has \$1,000 or more of gross income from an unrelated business must file Form 990-T, Exempt Organization Business Income Tax Return. An organization must pay estimated tax if it expects its tax for the year to be \$500 or more. The obligation to file Form 990-T is in addition to the obligation to file the annual information return or notice.

Automatic Revocation

When an exempt organization that is required to file an annual return (e.g., Form 990 or 990-EZ) or submit an annual electronic notice (Form 990-N) does not file the return or notice for 3 consecutive years, the organization's federal tax-exempt status is automatically revoked. Tax practitioners can check an organization's tax-exempt status and filings using the IRS's Tax Exempt Organization Search Tool [www.irs.gov/charities-non-profits/tax-exempt-organization-search].

In addition, the IRS sends a letter to each organization at its last known address, stating that its exempt status has been automatically revoked because it has not filed a required annual return or notice for 3 consecutive years. The effective date of automatic revocation for an organization that does not file a required annual return or notice for 3 consecutive years is the filing due date of the third year's return.

Reinstatement

To reinstate tax-exempt status following an automatic revocation, the organization must apply for reinstatement.

Streamlined Retroactive Reinstatement

Section 501(c)(6) organizations that were eligible to file Form 990-EZ or 990-N for the 3 years that caused their revocation may have their tax-exempt status retroactively reinstated to the date of revocation if they have not previously had their tax-exempt status automatically revoked. They must complete and submit Form 1024, Application for Recognition of Exemption Under Section 501(a) or Section 521 of the Internal Revenue Code, with the appropriate user fee no later than 15 months after the later of the date of the organization's Revocation Letter (CP-120A) or the date the organization appeared on the revocation list on the IRS website.

The IRS will not impose the I.R.C. § 6652(c) penalty for failure to file annual returns for the 3 consecutive tax years that caused the organization's tax-exempt status to be revoked if the organization is retroactively reinstated under this procedure and files properly completed and executed paper Forms 990-EZ for all such tax years. For any year for which the organization was eligible to file a Form 990-N, the organization is not required to file a prior-year Form 990-N or Form 990-EZ to avoid penalties. The organization should write "Retroactive Reinstatement" on the Forms 990-EZ and mail them to: Department of the Treasury, Internal Revenue Service, Ogden, UT 84201-0027.

Retroactive Reinstatement within 15 Months

Section 501(c)(6) organizations that cannot use the streamlined retroactive reinstatement process (such as those that were required to file Form 990 or Form 990-PF for any of the 3 years that caused revocation or those that were previously auto-revoked) may have their tax-exempt status retroactively reinstated to the date of revocation if they do the following:

1. Complete and submit Form 1024 with the appropriate user fee not later than 15 months after the later of the date on the organization's revocation letter (CP-120A) or the date the

organization appeared on the revocation list on the IRS website.

2. Include with the application a statement establishing that the organization had reasonable cause for its failure to file a required annual return for at least 1 of the 3 consecutive years in which it failed to file.
3. Include with the application a statement confirming that it has filed required returns for those 3 years and for any other tax years after such period and before the postmark date of the application for which required returns were due and not filed.
4. File properly completed and executed paper annual returns for the 3 consecutive years that caused the revocation and any following years. The organization should write “Retroactive Reinstatement” on these returns and mail them to the IRS address provided earlier.

The IRS will not impose the section 6652(c) penalty for failure to file annual returns for the 3 consecutive tax years that caused the organization to be revoked if the organization is retroactively reinstated under this procedure.

Retroactive Reinstatement after 15 Months

Organizations that apply for reinstatement more than 15 months after the later of the date on the organization’s revocation letter (CP-120A) or the date the organization appeared on the revocation list on the IRS website may have their tax-exempt status retroactively reinstated to the date of revocation if they satisfy all of the requirements for retroactive reinstatement within 15 months, and the reasonable cause statement the organization includes with its application establishes reasonable cause for its failure to file a required annual return for all 3 consecutive years in which it failed to file. The IRS will not impose the section 6652(c) penalty for failure to file annual returns for the 3 consecutive tax years that caused the organization to be revoked if the organization is retroactively reinstated under this procedure.

Postmark Date Reinstatement

Organizations may apply for reinstatement effective from the postmark date of their application if they complete and submit Form 1024 with the appropriate user fee.

PRACTITIONER NOTE

Reasonable Cause Statement

A reasonable cause statement establishes that an organization exercised ordinary business care and prudence in determining and attempting to comply with its annual reporting requirement. The statement should have a detailed description of all the facts and circumstances about why the organization failed to file, how it discovered the failure, and the steps it has taken or will take to avoid or mitigate future failures. For a detailed explanation, see section 8 of Rev. Proc. 2014-11, 2014-3 I.R.B. 411.

ISSUE 5: SCHEDULES K-2 AND K-3

This section explains when a partnership or S corporation with no foreign activity and no foreign owners may have to file Schedules K-2 and K-3.

Schedules K-2 and K-3 (Forms 1065, 1120-S, and 8865) were created to provide consistency in the reporting of international items to partners and shareholders. In tax years beginning in 2021 (with some transitional relief), flow-through entities with items of international tax relevance must complete the new schedules K-2 and K-3.

With several exceptions, partnerships, for example, must complete these schedules if the partnership has items of international tax relevance (typically, international activities or foreign partners). Any partnership required to file Form 1065, U.S. Return of Partnership Income, and that has items relevant to the determination of the US tax or certain withholding tax or reporting obligations of its partners under the international provisions of the Internal Revenue Code must complete the relevant parts of Schedules K-2 and K-3 (Form 1065). Similar rules apply to S corporations.

A partnership or S corporation with no foreign partners, no foreign source income, no assets generating foreign source income, and no foreign taxes paid or accrued may still need to report information on Schedules K-2 and K-3. This section briefly explains three scenarios where the entity may have to file Schedules K-2 and K-3. It then describes the domestic filing exception. Finally, this section explains the filing requirements and penalties for failure to file.

Partner Claims Foreign Tax Credit

If a partner claims the foreign tax credit, the partner generally needs certain information from the partnership on Schedule K-3 (Form 1065), Partner's Share of Income, Deductions, Credits, etc.—International (For Partner's Use Only),

Parts II and III, to complete Form 1116, Foreign Tax Credit. To claim the credit, the partner needs information about the source of the partnership's income and the value of its assets.

I.R.C. § 904 generally limits the foreign tax credit to the taxpayer's US tax rate multiplied by its foreign source taxable income. Foreign source taxable income is foreign source gross income less allocable expenses. This limit is applied at the partner or shareholder level, but it is not possible for the partner or shareholder to assume that all income of the partnership or S corporation is US source income and all expenses of the partnership or S corporation reduce US source income. Also, the allocation and apportionment of certain partner or shareholder level expenses take into account the owner's distributive shares of assets and income of the partnership and S corporation that are not otherwise reported on Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., or Schedule K-1 (Form 1120-S), Shareholder's Share of Income, Deductions, Credits, etc.

Example 11.18 Reporting for Foreign Tax Credit

US citizens Wilma Arnoldson and Greta Brown own equal interests in A&B partnership. A&B is a domestic partnership that uses a calendar tax year. In 2023, A&B had no foreign source income and no assets that generated foreign source income. It did not pay or accrue foreign taxes.

In 2023, Wilma paid \$2,000 of foreign income taxes on passive category income other than capital gains, which was reported to her on a qualified payee statement. Wilma did not pay or accrue any other foreign taxes and had no other foreign source income. Greta did not pay or accrue foreign income taxes. Greta reported to

A&B that she paid no foreign taxes for which she can claim a foreign tax credit.

Because Wilma must complete Form 1116 to claim a foreign tax credit, A&B must complete the relevant portions of Parts II and III of Schedules K-2 (Form 1065), Partners' Distributive Share Items—International, and K-3 (Form 1065) for Wilma [see www.irs.gov/businesses/schedules-k-2-and-k-3-frequently-asked-questions-forms-1065-1120s-and-8865, FAQ 12].

Partnership Sale of Personal Property

For sourcing purposes, personal property sold by a partnership is treated as sold by the partners [I.R.C. § 865(i)(5)]. Generally, income from the sale of certain personal property (excluding inventory) is sourced according to the residence of the seller. Income from the sale of personal property by a US resident is sourced in the United States, and income from the sale of personal property by a nonresident is sourced outside the United States. If the partner is a pass-through entity, the partnership will not know the residence of the seller partner. The partnership's or S corporation's gain on the sale of personal property is not separately stated on Schedules K and K-1 (Form 1065), but must be reported on Schedules K-2 and K-3 (Form 1065), Part II.

Research and Experimental Expenses

A partner's research and experimental (R&E) expense (which includes the distributive share of the partnership's R&E expense) is allocated and apportioned by the partner or shareholder [Treas. Reg. § 1.861-17(f)]. R&E expense is allocated and apportioned based on the gross receipts by Standard Industrial Code (SIC). R&E expense by SIC code is not reported on Schedules K and K-1

(Form 1065), but is reported on Schedules K-2 and K-3 (Form 1065), Part II. Also, the partner or shareholder needs Schedule K-3 (Form 1065), Part III, Section 1, for the partner's or shareholder's share of the partnership's or S corporation's gross receipts by SIC code for purposes of allocating and apportioning R&E expense.

Domestic Filing Exception

The 2022 Partnership Instructions for Schedules K-2 and K-3 (Form 1065) add a new exception from filing and furnishing Schedules K-2 and K-3 (Form 1065). The exception applies to a domestic partnership that has no or limited foreign activities. All the direct partners must be US citizens or resident aliens (or certain other domestic estates, trusts, single shareholder S corporations, and single-member LLCs). The partnership must notify the partners that they will not receive Schedule K-3 (Form 1065). The notice can be provided as an attachment to the Schedule K-1 (Form 1065). The partnership must not receive a timely request from any partner for Schedule K-3 (Form 1065) information.

A similar domestic filing exception applies to S corporations. The corporation must have no or limited foreign activities. It must give the notification to its shareholders that states that the shareholders will not receive Schedule K-3 (Form 1120-S) from the S corporation unless the shareholders request the schedule. It must not receive a timely request from any shareholder for Schedule K-3 (Form 1120-S) information. See the S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S) (2022).

This section explains the four tests for a partnership to qualify for the domestic filing exception, and the three tests for an S corporation to qualify for the exception. If the entity fails one or more of the tests, then it must complete the applicable sections of Schedules K-2 and K-3.

Test 1, No or Very Limited Foreign Activity

No foreign activity is defined as no foreign income taxes paid or accrued, including foreign taxes withheld; no foreign source income, gains, or losses; and no ownership interest in a foreign partnership, corporation, branch, or disregarded entity. Limited foreign activity is allowed, and partnerships and S corporations with brokerage accounts reporting de minimis foreign taxes paid may qualify for the domestic filing exception.

Limited foreign activity is passive category foreign income, on which not more than \$300 of foreign income taxes were paid or withheld. The income and taxes must be reported to the partnership or S corporation on a US payee statement, such as Form 1099-INT, Form 1099-DIV, or Schedule K-3 from another domestic partnership or S corporation. The \$300 exception corresponds to the \$300 threshold for filing Form 1116, Foreign Tax Credit.

Test 2, Domestic Individual Partners (Applies to Partnerships Only)

All the partners must be the following:

1. Individuals who are US citizens or resident aliens, or meet the substantial presence test
2. Domestic decedent's estates with only domestic individual beneficiaries
3. Domestic grantor trusts with only domestic individual grantors and domestic individual beneficiaries
4. Domestic nongrantor trusts with only domestic individual beneficiaries
5. Sole shareholder S corporations
6. Single member LLCs (disregarded entities) owned by any of the preceding

The domestic filing exception does not apply if any of the partners are other partnerships (regardless of whether those partnerships are domestic or foreign), C corporations, S corporations with more than one shareholder, trusts or estates with

foreign beneficiaries, nonresident alien individuals, or foreign entities. Thus, even if a partnership has no foreign activity, if it is owned wholly or in part by other partnerships or corporations, it does not qualify for the domestic filing exception. This test does not apply to S corporations because they cannot have a shareholder [other than an estate, a trust described in section 1361(c)(2), or an organization described in section 1361(c)(6)] who is not an individual, and cannot have a nonresident alien shareholder.

Test 3, Notification of Partners or Shareholders

If the first two tests are met, then the partnership or S corporation must notify each partner or shareholder that they will not receive a Schedule K-3 unless they request it. The notification must be provided no later than when the Schedule K-1 is furnished. The notification can be provided as an attachment to the Schedule K-1. There is no IRS form for the notification.

Test 4, Responses from Any Partner or Shareholder

If any partner or shareholder requests a Schedule K-3 by the 1-month date (1 month before the date the partnership files the Form 1065), then the partnership or S corporation must furnish a Schedule K-3 to the requesting partner or shareholder when the entity files its tax return. The entity must complete those parts and sections of Schedules K-2 and K-3 relevant to or requested by the requesting partner or shareholder. For example, if a partner requests the information that is reported in Part III, Section 2, Interest Expense Apportionment Factors, the partnership must complete and file Schedule K-2, Part III, Section 2, with respect to the partnership's total assets, and Schedule K-3, Part III, Section 2, with respect to the requesting partner's distributive share of the assets.

PRACTITIONER NOTE

Late Request

If a partner or shareholder requests a Schedule K-3 after the 1-month date, the entity must provide Schedule K-3 to the requesting owner before the later of the date on which the entity files its tax return, or 1 month from the date on which the entity received the request. However, the entity meets the domestic filing exception and does not have to file Schedules K-2 and K-3 with the IRS.

The entity does not have to complete Schedules K-3 for the non-requesting partners or shareholders. Once made, the request for a Schedule K-3 remains in effect for subsequent years, unless the requesting partner or shareholder revokes the request.

PRACTITIONER NOTE

Complete Return

The Schedules K-2 and K-3 instructions imply that a complete return must include Schedules K-2 and K-3 unless the entity notifies the IRS that the domestic filing exception applies. However, the entity cannot be certain that the exception applies until after the 1-month date. The 1-month date may be as late as 1 month before the extended due date of the return. To avoid a delay in filing, the tax practitioner may recommend that the entity obtain an earlier statement from its partners that they will not request Schedule K-3.

Form 1116 Exemption

The 2022 instructions for Schedules K-2 and K-3 state that if a partnership does not meet the domestic filing exception, it may meet the Form 1116 exemption to filing the Schedules K-2 and K-3. Under I.R.C. § 904(j), certain partners are not required to file a Form 1116, Foreign Tax

Credit (Individual, Estate, or Trust). A domestic partnership is not required to complete Schedules K-2 and K-3 if all partners are eligible for the Form 1116 exemption and the partnership receives notification of the partners' eligibility for such exemption by the 1-month date (as defined earlier). If a partnership receives notification from only some of the partners that they are eligible for the Form 1116 exemption, the partnership need not complete the Schedule K-3 for those exempt partners but must complete the Schedules K-2 and K-3 for the other partners to the extent that the partnership does not qualify for the domestic filing exception.

A partnership that does not have or receive sufficient information or notice regarding a direct or indirect partner must presume such partner is eligible to claim a foreign tax credit and such partner would have to file a Form 1116 or Form 1118, Foreign Tax Credit - Corporations, to claim a credit. The partnership must complete the Schedules K-2 and K-3, including Parts II and III, accordingly. A similar exemption applies to S corporations.

The 13 Parts of Schedules K-2 and K-3

The new schedules require more detailed and more complete reporting than partnerships and S corporations may have been providing previously to partners and shareholders, which is necessary for partners and shareholders to accurately complete their own returns. Schedule K-2 is an entity form. The entity files only one Schedule K-2 and reports the entity totals. The entity must file a separate Schedule K-3 for each partner or shareholder, and furnish the form to each partner or shareholder with Schedule K-1. The entries on Schedule K-3 report the pro-rata or special allocations to the partners or shareholders. **Figure 11.13** shows the parts of Schedules K-2 and K-3 (Form 1065), and indicates which parts apply to S corporations.

FIGURE 11.13
Parts of Schedules K-2 and K-3 (Form 1065)

Part	Title	Topic	Applies to S Corporations
I	Partnership's Other Current Year International Information	All other	X
II	Foreign Tax Credit Limitation	Foreign tax credit	X
III	Other Information for Preparation of Form 1116 or 1118	Foreign tax credit	X
IV	Information on Partners' Section 250 Deduction With Respect to Foreign-Derived Intangible Income (FDII)	FDII	
V	Distributions from Foreign Corporations to Partnership	Previously-taxed earnings and profits	X
VI	Information on Partner's Section 951 (a)(1) and Section 951A Inclusions	Subpart F/global intangible low-taxed income (GILTI)	X
VII	Information to Complete Form 8621	Passive foreign investment company	X
VIII	Partnership's Interest in Foreign Corporation Income (Section 960)	Deemed foreign tax credit	X
IX	Partners' Information for Base Erosion and Anti-Abuse Tax (Section 59A)	Base erosion and anti-abuse tax	
X	Foreign Partners' Character and Source of Income and Deductions	Effectively connected income and fixed, determinable, annual, or periodical income	
XI	Section 871(m) Covered Partnerships	Publicly traded partnerships	
XII	Reserved for Future Use	N/A	
XIII	Foreign Partner's Distributive Share of Deemed Sale Items on Transfer of a Partnership Interest	1040-NR and 1120-F	

Filing Requirements

If the domestic filing exception does not apply, the partnership or entity must complete only the relevant portions of Schedules K-2 and K-3. In most cases, only two or three parts of the schedules will be required. **Figure 11.14** is a guide as to what type of partner status or partnership activities will requiring the partnership to complete a particular part of Schedules K-2 and K-3 (Form 1065).

FIGURE 11.14
Filing Requirements

Part	Filing Requirements
I	General information as needed
II and III	Partner's status: Direct or indirect partner eligible for a foreign tax credit (individuals, corporations, trusts and estates)
IV	Partner's status: Direct or indirect domestic C corporation partner
V	Partnership's activities: Directly or indirectly received distributions from previously-taxed earnings and profits of foreign corporations (i.e., files Form 5471, Schedule P)
VI	Partnership's activities: Directly or indirectly owns a controlled foreign corporation
VII	Partnership's activities: Directly or indirectly owns a passive foreign investment company
VIII	Partner's status: Direct or indirect domestic C corporation partner or partner eligible to make a Section 962 election Partnership's activities: Directly or indirectly owns a controlled foreign corporation
IX	Partner's status: Direct or indirect large domestic C corporation partner (average annual gross receipts \$500,000,000 or more)
X	Partner's status: Direct or indirect foreign partner
XI	Partnership's activities: Partnership is a publicly traded partnership
XIII	Partner's status: Direct or indirect foreign partner that sold or transferred a partnership interest, in whole or in part

PRACTITIONER NOTE

Partner's Status

Partnerships can rely on Forms W-9, Request for Taxpayer Identification Number and Certification and W-8-BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals), to determine the domestic or foreign status of a partner. Therefore, a partnership is generally not required to obtain information from its direct or indirect partners to determine its filing requirements. However, if a partnership does not have sufficient information to determine each partner's status, the partnership must presume that it has corporate or foreign partners and must complete all applicable sections of Schedules K-2 and K-3.

Penalties

The penalty for failure to file a complete tax return is \$235 (for returns required to be filed in 2024) per partner or shareholder per month up to 12 months [I.R.C. § 6698 (partnerships) and I.R.C. § 6699 (S corporations)]. A second penalty applies to a failure to report all required information on Schedules K-1 and K-3 and furnish the form to the partner or shareholder. If the failure is due to intentional disregard, the penalty increases [I.R.C. § 6722]. Reasonable cause relief may apply to these penalties [I.R.C. § 6724].

PRACTITIONER NOTE

Transition Period Relief

Before 2022, penalty relief was available under Notice 2021-39. Transition penalty relief was granted if the taxpayer made a good faith effort to comply with the Schedules K-2 and K-3 filing requirements. No additional penalty relief was granted for 2022 and subsequent years, but the reasonable cause exception may apply.

CROSS-REFERENCE

Beneficial Ownership Reporting

Effective January 1, 2024, new rules apply for reporting beneficial owners of an entity. See the "New and Expiring Legislation" chapter in this book for a discussion of the new rules.
