2026 NATIONAL INCOME TAX WORKBOOK

Chapter 4: Business Entity Tax Issues

Land Grant University
Tax Education Foundation

1

LEARNING OBJECTIVES

- Know when a taxpayer can deduct partnership losses
- Understand when partnership distributions are taxable
- Explain how an S corporation shareholder's stock and debt bases limit losses
- Understand when S corporation distributions are taxable

2

LEARNING OBJECTIVES

- Recognize when an amateur sports organization may qualify for tax-exempt status
- Know how to apply for tax-exempt status on Form 1023-EZ
- Explain when an organization qualifies as a labor organization

3

P. 133

PARTNERSHIP LOSSES

4

P. 133

LOSS LIMITED TO OUTSIDE BASIS

Outside basis: the partner's basis in their partnership interest

Outside basis may limit the amount of partnership losses that the partner can use to offset non-partnership income

5

P. 133

LOSS LIMITED TO OUTSIDE BASIS

I.R.C. § 704(d): A partner's distributive share of a partnership loss is allowed only to the extent of the adjusted basis of the partner's interest at the end of the partnership's loss year

Excess loss over the partner's basis is carried over to the next tax year in which the partner has basis available

6

P. 133

INITIAL OUTSIDE BASIS

No gain or loss recognized when a partner acquires a partnership interest in exchange for property/cash

Outside basis = cash contributed + contributing partner's adjusted basis in contributed property

- *If a **purchased interest** → cost basis*
- *If an interest **acquired by gift** → carryover basis*
- *If an **inherited** interest → adjusted to date-of-death value*

7

PP. 133-134

BASIS ADJUSTMENTS

Outside basis is **increased** by:

- *Additional contributions*
- *Partner's share of partnership liabilities*
- *Partner's distributive share of taxable and nontaxable income*

8

BASIS ADJUSTMENTS

PP. 133-134

Outside basis is **decreased** (not below zero) by:

- ***Money distributed*** *and adjusted basis of* ***property distributed*** *to the partner (including decreased share of partnership liabilities)*
- *Partner's* ***distributive share of partnership losses*** *(including capital losses)*
- *Partner's* ***distributive share of nondeductible partnership expenses*** *that are not capital expenditures*

9

INITIAL BASIS – I.R.C. §358(a)

Basis of property contributed

\+ Gain recognized by Shareholder

\- Boot (property other than stock) received

\- Liabilities acquired by the corporation from the Shareholder

= Basis of Stock Received

10

P. 134

BASIS ADJUSTMENTS

If current year losses exceed adjusted outside basis

- The loss limitation is allocated to each type of loss or deduction
- *This includes any amounts carried over*

11

P. 134

EXAMPLE 4.2: LOSSES EXCEED BASIS

Dakota and Kaya are equal partners in Compass Construction, LLC

Beginning outside basis: $50,000 (each)

2026: $20,000 non-separately stated income + $150,000 long-term capital loss

12

P. 134

EXAMPLE 4.2: LOSSES EXCEED BASIS

- Each partner increases basis from $50,000 to $60,000 (their $10,000 share of income)
- Each partner's $75,000 share of long-term capital loss is limited to $60,000
- Remaining $15,000 (per partner) is carried forward as a long-term capital loss carryover

13

EFFECT OF PARTNERSHIP LIABILITIES ON BASIS

P. 134

Increase in partner's share of liabilities → treated as cash **contributions**

Decrease in partner's share of liabilities → treated as a **distribution** of money, reducing outside basis (not below zero)

14

PARTNER'S SHARE OF RECOURSE LIABILITIES

PP. 134-135

Allocate **recourse** and **nonrecourse** liabilities among partners

Recourse liability: liability that any partner (or related person) bears the economic risk of loss

- *Each partner's share = portion of liability for which that partner (or related person) bears economic risk*

15

PARTNER'S SHARE OF RECOURSE LIABILITIES

PP. 134-135

Risk of loss determined by the partner's payment obligation on an immediate hypothetical **(constructive) liquidation**:

- *All liabilities become payable in full*
- *All assets (except property securing nonrecourse liability) have zero value*
- *Partnership disposes of all property in a taxable transaction for no consideration*
- *All income/gain/loss/deduction items allocated to partners*
- *Partnership liquidates*

16

PARTNER'S SHARE OF RECOURSE LIABILITIES

P. 135

Partnership has no assets

The recourse liabilities must still be paid.

A partner's obligation is based on the following:

- *Contractual obligations outside the partnership agreement (e.g., guarantees, reimbursement agreements, etc.)*
- *Obligations imposed by the partnership agreement*
- *Payment obligations imposed by state law*

17

PRACTITIONER NOTE: LLC MEMBERS AND RECOURSE LIABILITIES

P. 135

Most LLC members have no personal responsibility for business liability under state law → LLC liabilities may be classified as **nonrecourse**

However, lenders may require LLC members to personally guarantee debts → those liabilities become **recourse** liabilities

18

EXAMPLE 4.4: DETERMINING A PARTNER'S SHARE OF PARTNERSHIP RECOURSE LIABILITY

PP. 135-136

- *Ross, Dallas, and Andre formed Park Avenue Real Estate Partnership*
- *Ross & Dallas contributed $350,000 each*
- *Andre contributed $700,000*
- *Partnership borrowed $200,000 (unsecured; guaranteed proportionate to capital interests: Ross ¼, Dallas ¼, Andre ½)*
- *Partnership purchased real estate for $1.6 million*

19

EXAMPLE 4.4: DETERMINING A PARTNER'S SHARE OF PARTNERSHIP RECOURSE LIABILITY

PP. 135-136

Constructive Liquidation Result:

Partnership has a loss of $1.6 million

Loan becomes payable	Value of real estate reduced to $0 and disposed of for no consideration

$1.6 million loss allocated as follows:

Ross: (25% x $1.6 million) = $400,000	Dallas: (25% x $1.6 million) = $400,000	Andre: (50% x $1.6 million) = $800,000

20

EXAMPLE 4.4: DETERMINING A PARTNER'S SHARE OF PARTNERSHIP RECOURSE LIABILITY

PP. 135-136

Share of Recourse Liability:			
Ross, Dallas, and Andre must pay off the $200,000 loan	Ross's share is $50,000	Dallas's share is $50,000	Andre's share is $100,000

Each partner's outside basis is increased for their share of the recourse liability

21

PARTNER'S SHARE OF NONRECOURSE LIABILITIES

PP. 135-136

Nonrecourse liability: no partner or related person bears economic risk of loss

- ***Example***: *mortgage loan secured by the property (lender's only remedy is foreclosure)*

Related person: Defined in Treas. Reg. § 1.752-4(b)

- *If an affiliate of any partner, member, or family member has any risk, treated as recourse*

Treas. Reg. § 1.752-3 for allocation rules

22

P. 137

PARTNERSHIP DISTRIBUTIONS

23

P. 137

CASH DISTRIBUTIONS

- Partners generally do not recognize gain when the partnership distributes cash
- Cash distributions reduce outside basis
- **Exception**: A distribution in **excess** of outside basis = taxable capital gain (gain from sale or exchange of a partnership interest)
- To calculate gain, outside basis is determined **immediately before** the distribution

24

PRACTITIONER NOTE: TIMING OF DISTRIBUTIONS

P. 137

Draws against a partner's distributive share of income are treated as **current distributions** made on the **last day** of the partnership tax year

A **deemed distribution** resulting from a **decrease in a partner's share of partnership liabilities** is treated as an advance or drawing to the extent of the partner's distributive share of income

25

P. 138

RECOGNITION OF LOSS

Distribution of **cash and/or § 751 "hot assets"** (unrealized receivables and inventory) in **liquidation** of a partner's interest

- *The partner recognizes a loss,* ***but only if adjusted outside basis exceeds****:*
- *Money distributed + basis of unrealized receivables and inventory distributed*

No loss is recognized if the partner receives any property other than money, unrealized receivables, or inventory

26

EXAMPLES 4.7: LIQUIDATING DISTRIBUTIONS

P. 138

Liquidating Distributions of Cash and Inventory

Jacqui: *$100,000 basis; received $50,000 + inventory with $30,000 basis*	*Recognizes* ***$20,000 capital loss*** *[$100,000 – ($50,000 + $30,000)]*

27

EXAMPLES 4.8: LIQUIDATING DISTRIBUTIONS

P. 138

Liquidating Distribution Includes Other Property

Same facts as 4.7 but Jacqui also receives a distribution of real property with $20,000 basis	*Jacqui recognizes* ***no loss*** *(received property other than money, unrealized receivables, and inventory)*	*Remaining $10,000 basis is assigned to the real property (I.R.C. § 732(c))*

28

EXAMPLE 4.9: REDUCTION IN LIABILITIES TREATED AS A CASH DISTRIBUTION

P. 138

- ***Beau***: *$15,000 outside basis in Wilson Family Partnership*
- *Received $12,500 liquidating cash distribution*
- *Liquidation also reduced Beau's $10,000 share of partnership liabilities to $0*
- *Beau is treated as having received $22,500 ($12,500 + $10,000) cash*
- **Result**: $7,500 gain ($22,500 - $15,000)

29

DISTRIBUTION OF MARKETABLE SECURITIES

P. 138

- **CASH:** Distribution of **marketable securities** from a non-investment partnership
- Cash distribution amount = FMV of securities on distribution date
- Gain is reduced by partner's share of net appreciation in those securities

30

P. 139

DISTRIBUTIONS OF PROPERTY: CURRENT VS. LIQUIDATING

LIQUIDATING DISTRIBUTION: terminates a partner's **entire interest** (by a single distribution or series of distributions)

- *Not considered liquidated until final distribution is made*

CURRENT DISTRIBUTION: any distribution that is not in liquidation of a partner's entire interest; includes partial liquidations and distributions of distributive share of partnership income

31

CURRENT DISTRIBUTIONS

P. 139

Non-Cash distributions of property:

- *Partner's basis = partnership's basis in distributed property*

Transferee **reduces outside basis** by:

- *Money received + basis in distributed property*

§ 732(a)(2) basis in distributed property **cannot** exceed:

- *Outside basis – cash received*

32

P. 139

CROSS-REFERENCE: FORM 7217 REPORTING DISTRIBUTIONS

Form 7217, Partner's Report of Property Distributed by a Partnership, reports all distributions of property a partner receives from a partnership

Used for both non-liquidating and liquidating distributions to report the basis of distributed property

See pages 129-131 in the **2025 National Income Tax Workbook** for a discussion on reporting distributions

33

P. 139

ORDERING RULES

FIRST PRIORITY: Partner's basis is first assigned to "hot assets" § 751 assets

SECOND PRIORITY: Any remaining basis allocated to the other distributed assets

34

OUTSIDE BASIS LESS THAN TOTAL BASIS OF DISTRIBUTED ASSETS

P. 139

FIRST *apply to assets with unrealized depreciation (up to the unrealized depreciation amount)*

Any remaining shortfall is then spread across the other assets in proportion to their basis

35

P. 140

LIQUIDATING DISTRIBUTIONS

- *Partner's basis in distributed property = basis of the partner's partnership interest*
- *Partner's holding period includes the partnership's holding period*
- *Distribution of multiple assets, any decrease is allocated among the assets in the same fashion as current distributions (I.R.C. § 732(c))*

36

EXAMPLE 4.12: LLC LIQUIDATION – BASIS DECREASE

P. 140

Frank → *$90,000 outside basis in LLC*

Liquidating distribution to Frank

- *Elm Avenue property (basis $50,000/FMV $100,000) +*
- *Poplar Lane property (basis $120,000/FMV $100,000)*

Total basis received = $170,000

- *Exceeds outside basis → $80,000 decrease*

37

P. 140

EXAMPLE 4.12: ALLOCATING THE $ 80,000 BASIS DECREASE

First: *$20,000 allocated to Poplar Lane property*

- Unrealized depreciation in value (basis $120,000 – FMV $100,000)
- Poplar Lane property basis reduced to $100,000

Second*: Remaining $60,000 allocated proportionally to* ***both*** *properties*

- Elm Avenue adjusted basis = $30,000 ($50,000 basis reduced by 1/3 of $60,000)
- Poplar Lane adjusted basis = $60,000 ($100,000 basis reduced by 2/3 of $60,000)

38

P. 140

RETIREMENT OR DEATH OF A PARTNER

I.R.C. § 736 governs liquidating payments to retiring or deceased partners

Payments are treated as distributions in exchange for the partner's interest

These payments are subject to § 731 and § 751 rules

39

P. 140

RETIREMENT OR DEATH OF A PARTNER

A **retired partner** is treated as continuing as a partner **until fully paid** for the interest

- *A two-person partnership continues to be taxed as a partnership until retirement payments are complete*
- *Liabilities allocated to the partner remain in the retired partner's basis until contractually removed*

40

P. 140

PRACTITIONER NOTE: SERVICE PARTNERSHIPS

I.R.C. § 736(a) governs retiring general partners in service partnerships

Liquidating distributions for unrealized receivables or goodwill: treated as distributive share (if tied to partnership income) or as guaranteed payment (if not tied to partnership income)

41

P. 141

EXAMPLE 4.13: DEFERRAL OF GAIN

- *LLC made four $50,000 annual liquidating payments to Levi*
- *Levi retained 25% share of LLC liabilities until he received the last payment*
- *Levi's outside basis: $200,000 ($150,000 tax capital + $50,000 share of liabilities)*
- *Levi recovers his entire basis before reporting gain; the deemed distribution for release of liabilities does not occur until Year 4*
- **Result**: $50,000 gain recognized only in Year 4

42

PRACTITIONER NOTE: DEATH OF A PARTNER

P. 141

- **Heirs may receive a basis in the inherited partnership interest equal to FMV on date of death (or alternate valuation date, if used by the estate)**
- **PLUS** the partner's share of liabilities
- **LESS** items of income in respect of a decedent

43

P. 141-142

GUARANTEED PAYMENTS

- **Payments made by the partnership to a partner for services or use of capital, without regard to income of the partnership**
  - Generally deductible by the partnership (must be capitalized if for acquiring/constructing a capital asset)
  - Included in the recipient partner's **ordinary income** (if made for services in acquiring a capital asset)
- **Do not** decrease outside basis

44

P. 142

OBSERVATION: WAGES

- **Partners do not receive wages from the partnership**
- In contrast, S corporation shareholders who provide labor/management must receive **reasonable compensation**

45

P. 142

CROSS-REFERENCE: SE TAX ON DISTRIBUTIONS

- A partner's distributive share of partnership income is generally SE income subject to SE tax
- Guaranteed payments from an LLC conducting a trade or business are treated as SE income
- I.R.C. § 1402(a)(13): limited partners may exclude their distributive share from SE income

46

CROSS-REFERENCE: SE TAX ON DISTRIBUTIONS

P. 142

- *Soroban Capital Partners v. Commissioner* (161 T.C. 310 (2023)): functional analysis test applied to determine whether limited partners are passive investors
- *Sirius Solutions v. Commissioner* (No. 24-60240 (5th Cir. 2026)): Fifth Circuit rejected the functional analysis approach; a limited partner is a partner in a limited partnership that has limited liability
- *See* **"Rulings and Cases"** chapter for further discussion

47

P. 142

DISPROPORTIONATE DISTRIBUTIONS

When a partner receives something other than their pro rata share of certain ***ordinary income assets (hot assets)***

- Distribution recharacterized as a sale or exchange of property
- Capital asset = ordinary income (not converted to capital gain)

48

P. 142

DISPROPORTIONATE DISTRIBUTIONS

§ 751(b) overrides normal tax-free treatment of partnership distributions

Triggered when a distribution causes a **shift** between:

- *The partner's share of "hot assets" (unrealized receivables or appreciated inventory)*
- *The partner's share of other partnership property*

The shifted portion is treated as a **taxable sale**, not a tax-free distribution

49

P. 143

I.R.C. § 751(B) HOT ASSETS

Unrealized receivables: *rights to receive payment for goods/services not yet in income*

- *Includes depreciation recapture and soil/water conservation recapture*
- *Depreciation recapture is an* ***unrealized receivable with no basis***

Substantially appreciated inventory: inventory that has appreciated by more than 20%

50

TRANSACTIONS SUBJECT TO I.R.C. § 751(B)

P. 143

*Proposed regulations [REG-151416-06] adopt a **hypothetical sale approach** to determine whether there has been a disproportionate distribution of hot assets*

Proposed **Hypothetical Sale Approach**

- ***Compare** ordinary income if partnership sold all assets immediately **before** the distribution, to*
- *Ordinary income if partnership sold all assets immediately **after** the distribution + ordinary income the distributee partner would recognize on immediate sale of distributed property*

51

TRANSACTIONS SUBJECT TO I.R.C. § 751(B)

P. 143

*If there is no difference → § 751(b) **does not** apply*

If ordinary income is shifted among partners → adjustment required

52

TAX CONSEQUENCES OF § 751(B) DISTRIBUTION

P. 143

*Proposed regulations allow any **reasonable approach** to determine an I.R.C. § 751(b) adjustment*

Two reasonable approaches:

- *Hot Asset Sale Approach*
- *Deemed Gain Approach*

53

P. 143

HOT ASSET SALE APPROACH

*Partner with a **reduced interest in hot assets** are deemed to have received a **distribution of the diminished value** of the hot assets*

Partner is deemed to have sold the relinquished property to the partnership **immediately before the deemed distribution**

54

P. 143

DEEMED GAIN APPROACH

Partnership recognizes ordinary income equal to the aggregate amount of any reduced interest in hot assets

Deemed ordinary gain is allocated to partners with a reduced interest in hot assets

Basis of remaining hot assets is increased to reflect the ordinary income recognized

55

PP. 143-145

EXAMPLE 4.16: GAIN ON DISTRIBUTION OF LAND RECHARACTERIZED – HOT ASSET SALE APPROACH

- PRS Partnership: Paul, Robert, and Stephanie are equal partners ($100,000 outside basis each)
- PRS Partnership Assets:

	Basis	FMV
• *Inventory:*	$ 240,000	$ 300,000
• *Land:*	60,000	150,000
• ***Total:***	***$ 300,000***	***$ 450,000***

- **2026**: PRS distributed the land to Paul in complete liquidation of his 1/3 interest

56

PP. 143-145

EXAMPLE 4.16: GAIN ON DISTRIBUTION OF LAND RECHARACTERIZED – HOT ASSET SALE APPROACH

Pre-distribution deemed sale:

- *If PRS sold all its assets for FMV = $60,000 of ordinary income (FMV Inventory – Basis Inventory)*
- *$90,000 capital gain (FMV Land – Basis Land)*
- ***Partnership allocates** $20,000 of ordinary income and $30,000 capital gain to each partner*

57

PP. 143-145

EXAMPLE 4.16: GAIN ON DISTRIBUTION OF LAND RECHARACTERIZED – HOT ASSET SALE APPROACH

Post-distribution

- *If Paul and PRS sold the assets for FMV*
- *PRS would have $60,000 ordinary income and would allocate $30,000 to Robert and Stephanie*
- *Paul's outside basis = $100,000 and he would have a $100,000 basis in the distributed land*
- *Paul would have a $50,000 capital gain on the sale of the land (FMV Land – Paul's Basis in Land)*

58

PP. 143-145

EXAMPLE 4.16: GAIN ON DISTRIBUTION OF LAND RECHARACTERIZED – HOT ASSET SALE APPROACH

Post-distribution (cont'd)

- *Paul's $20,000 ordinary income and $30,000 capital have been converted to $50,000 capital gain → disproportionate distribution exists*

Hot Asset Sale Approach

- *Paul deemed to have received a current distribution of $100,000 ($300,000 ÷ 3) inventory with an $80,000 ($240,000 ÷ 3) basis*
- *Paul has no gain on distribution*
- *Paul takes $80,000 transferred basis in the inventory and outside basis reduced to $20,000*

59

PP. 143-145

EXAMPLE 4.16: GAIN ON DISTRIBUTION OF LAND RECHARACTERIZED – HOT ASSET SALE APPROACH

Hot Asset Sale Approach (cont'd)

- *Paul is then deemed to transfer the inventory to PRS in exchange for $100,000 of land*
  - PRS Basis in $100,000 portion of land = $40,000 [($100,000 ÷ $150,000) x $60,000]
  - PRS has a $60,000 capital gain ($100,000 - $40,000)
  - PRS allocates capital gain to Robert and Stephanie
- *Paul takes $100,000 cost basis in land*
- *PRS takes $100,000 cost basis in the inventory*

60

PP. 143-145

EXAMPLE 4.16: GAIN ON DISTRIBUTION OF LAND RECHARACTERIZED – HOT ASSET SALE APPROACH

Hot Asset Sale Approach (cont'd)

- *PRS makes a liquidating distribution of the remaining $50,000 of land to Paul*
- Paul has no gain and his basis in this part of the land is his remaining $20,000 outside basis
- *Paul's total basis in the land is now $120,000*
- *Thus, Paul has $20,000 ordinary income and will have a $30,000 capital gain if he sells the land*

61

PP. 143-145

EXAMPLE 4.16: GAIN ON DISTRIBUTION OF LAND RECHARACTERIZED – HOT ASSET SALE APPROACH

Hot Asset Sale Approach (cont'd)

- *PRS has a $100,000 cost basis in the exchanged inventory and a $160,000 [($300,000 - $100,000) x ($240,000 ÷ $300,000)] basis in the remaining inventory*
- *If it sells the inventory, it will have $40,000 ($300,000 - $260,000) ordinary income → allocates $20,000 (each) to Stephanie and Robert*

62

PP. 143-145

EXAMPLE 4.16: GAIN ON DISTRIBUTION OF LAND RECHARACTERIZED – HOT ASSET SALE APPROACH

Deemed Total Sale Before Distribution

- *Each partner allocated $20,000 ordinary income and $30,000 capital gain*

Deemed Total Sale of and Distributed Assets After the Distribution

- *Each partner has $20,000 ordinary income and $30,000 capital gain*

63

PRACTITIONER NOTE: DISGUISED SALE RULES

P. 145

If a partner contributes appreciated property to a partnership and the partnership distributes cash or other property back to the partner, the partner generally does not recognize gain

To prevent abuse, I.R.C. §707(a)(2)(B) treats a contribution and related distribution as a **deemed sale** if:

- *The distribution would not have been made but for the contribution; and*
- *The subsequent transfer is not dependent on entrepreneurial risks of partnership operations*

Presumption of sale if within a 2-year period a partner transfers property to a partnership and the partnership transfers money or other consideration back to the partner

64

P. 146

S CORPORATION LOSSES

65

INITIAL STOCK BASIS – I.R.C. §358(a)

	Basis of property contributed
+	Gain recognized by Shareholder
-	Boot (property other than stock) received
-	Liabilities acquired by the corporation from the Shareholder
=	Basis of Stock Received

66

P. 146

S CORPORATION STOCK BASIS

S corporation shareholder losses and deductions cannot exceed the shareholder's **stock basis + debt basis**

Shareholder's Annual Stock Basis

- *Basis at Acquisition or Beginning of Year*
- *+ Increased by share of Corporation Income (Reported on K-1)*
- *– Decreased by share of deductions, losses, and distributions*
- *= Year End Basis (beginning of following year)*

67

INITIAL STOCK BASIS P 146-147

How was the stock obtained?	Basis Calculation	I.R.C. or Treas. Reg.
Bought it from another Shareholder	Cost – how much did you pay for it	§1012
Inherited	FMV on date of death or alternative valuation date	§1014
Gift before 01/01/1977	Donor's basis adjusted by gift tax paid or FMV on date of gift, whichever is lower	§1015(d)(1)
Gift after 12/31/1976	Donor's basis adjusted by gift tax paid	§1015(d)(6)
Tax-free reorganization	Basis of stock given up	§358(a)
Compensation	FMV on date included in income	Treas. Reg. §1.86-4(b)

68

P. 146

EXAMPLE 4.17: LOSSES EXCEED BASIS

Pam: sole shareholder of S corp

- *Beginning 2026 stock basis: $30,000*
- *In 2026, S corp reports a $40,000 ordinary loss*
- *Pam's loss deduction limited to $30,000 basis*
- *Remaining $10,000 loss carries forward*

69

P. 147

EXAMPLE 4.18: INCOME IN RESPECT OF A DECEDENT

Jeannie inherited all stock in S corp from father in 2026

FMV on date of death: $1 million; S corp had accounts receivable of $450,000

Jeannie's initial stock basis: **$550,000** ($1,000,000 - $450,000)

When S corp collects the receivables, Jeannie includes them in income and her stock basis increases to $1,000,000

70

EXAMPLE 4.18: INCOME IN RESPECT OF A DECEDENT

P. 147

Jeannie inherited all stock in S corp from father in 2026

FMV on date of death:

- $1 million
- S Corp had A/R of $450,000

Jeannie's initial stock basis: **$550,000**

- ($1,000,000 FMV on DofD - $450,000 A/R)

When S corp collects the receivables,

- Jeannie includes A/R on K-1
- Her stock basis increases to $1,000,000

71

P. 147

STOCK BASIS ADJUSTMENTS

ADJUSTED ANNUALLY on the last day of the S corporation's tax year.

ORDERING RULES:

- ***Income items*** *(including tax-exempt income, separately stated income, and excess depletion)* → *increase basis*
- ***Distributions*** *(other than dividends from AE&P)* → *decrease basis (not below zero)*
- ***Nondeductible, noncapital expenses and depletion*** → *decrease basis*
- ***Items of loss and deduction*** → *decrease basis*

72

EXAMPLE 4.19: ADJUSTING SHAREHOLDER BASIS

PP. 147-149

- Cheryl (sole shareholder of S Corp, no AE&P, no debt basis)
- January 1, 2026: beginning stock basis = $15,000
- $20,000 ordinary loss
- $4,000 net § 1231 gain
- Distributed $12,000 to Cheryl

73

EXAMPLE 4.19: ADJUSTING SHAREHOLDER BASIS

P. 147-149

Cheryl's Adjusted Stock Basis:

- Cheryl's loss limited to $7,000
- $13,000 suspended loss carries forward

Beginning Stock Basis	$ 15,000
+ Income items	4,000
Basis before distribution	19,000
– Distribution	<12,000>
Basis before loss	7,000
– Allowable loss	<7,000>
Ending 2026 stock basis	$ 0

74

CROSS-REFERENCE: FORM 7203 REQUIREMENT

P. 149

A shareholder must file Form 7203, S Corporation Shareholder Stock and Debt Basis Limitations, if the Schedule K-1 (Form 1120-S) reports:

- *A deduction for an aggregate loss (including carryover loss)*
- *A nondividend distribution*
- *A disposition of S corporation stock (regardless of gain recognition)*
- *A loan repayment from an S corporation*

See pages 391-406 in the **2023 National Income Tax Workbook** for discussion

75

NONDEDUCTIBLE EXPENSES

P. 149

Noncapital, nondeductible expenses reduce basis before other items of loss and deduction

If nondeductible items exceed available basis → basis reduced to zero; no carryforward of excess nondeductible items

Election [Treas. Reg. § 1.1367-1(g)]: Shareholder may elect to decrease basis by items of loss or deduction **before** nondeductible expenses

- *If elected, excess nondeductible expenses treated as nondeductible expenses in the next tax year*

76

P. 149

S CORPORATION DEBT BASIS

- A shareholder obtains debt basis by **loaning money or property** (in which the shareholder has basis) to the S corp
- Must be **bona fide indebtedness** from the corporation to the shareholder
- A mere **loan guarantee** does NOT create debt basis
- Debt basis is created only when the shareholder makes an **actual economic outlay** (payment on the obligation)

77

P. 149

EXAMPLE 4.20: SHAREHOLDER LOAN

- Ola (25% shareholder in S corp): beginning stock basis = $60,000
- $50,000 distribution → stock basis reduced to $10,000
- S corp had $100,000 loss; Ola's share = $25,000
- Ola's loss limited to $10,000 remaining basis
- If Ola loans S corp $40,000 → Debt basis = $40,000
  - *$10,000 stock basis absorbs first $10,000 of loss → stock basis = $0*
  - *$40,000 debt basis absorbs remaining $15,000 → debt basis = $25,000*
  - ***Ola's full $25,000 is allowable***

78

P. 150

LOAN GUARANTEES

NO Debt Basis

- *Except: payment of principle on guaranteed obligation*

Payment in a **later year** does not create basis in the **earlier year** the debt was guaranteed

79

P. 150

EXAMPLE 4.21: SHAREHOLDER GUARANTEE

Jade (sole shareholder) guaranteed a $100,000 bank loan to Glacier, Inc. in 2026

- ***No effect on 2026 basis***

In 2027, Glacier unable to make loan payments and Jade used $20,000 of her personal funds to pay on the loan principal

- ***$20,000 basis increase in 2027***

80

P. 150

LOAN RESTRUCTURING

- **Rev. Rul. 75-144**:
  - Shareholder executed a promissory note substituting for the corporation's note
  - The corporation's debt accrues to the shareholder
  - Basis created in corporation's indebtedness in the year the note was executed

81

P. 151

RELATED PARTY LOANS

- *Prashker v. Commissioner:* Loan must run **directly** between the corporation and the shareholder; no attributed basis for loans from related parties
- *Culnen v. Commissioner*: A shareholder in two S corps found to have debt basis where one S corp advanced funds to another, recorded consistently as a shareholder loan
- **Disregarded Entity Exception**: Loans through single-member LLCs → treated as a loan from the LLC's sole member → creates debt basis

82

P. 151

BACK-TO-BACK LOANS

Basis if Bonafide Indebtedness

- Shareholder borrows from one entity (possibly a related entity) and lends to S corporation

83

CIRCULAR LOANS

PP. 151-152

Oren v. Commissioner, T.C. Memo 2002-172

- Shareholder borrowed from one controlled entity and loaned to other controlled entities which loaned back to original source
- No actual economic outlays or amounts at risk;
- **No debt basis created**

84

ADJUSTMENTS TO S CORPORATION DEBT BASIS

P. 152

If a shareholder's portion of losses **does not exceed** stock basis → **no adjustment to debt basis**

If losses **exceed** stock basis, debt basis adjusted as follows:

- *In the loss year: after stock basis is reduced to zero, shareholder reduces debt basis*
- *In a subsequent year with income: debt basis is restored first, before stock basis is increased*

85

P. 152

EXAMPLE 4.23: DEBT BASIS ADJUSTMENTS

2025: Hugo (sole shareholder) had a $60,000 stock basis + $50,000 debt basis; S Corp passes through **$100,000 ORDINARY LOSS on K-1**

2025 result: Stock basis → $0; debt basis → $10,000 ($50,000 - $40,000 overflow)

2026: S Corp passes through **$140,000 ORDINARY INCOME on K-1**

2026 result: Debt basis → restored to $50,000; stock basis → $100,000

86

P. 153

S CORPORATION DISTRIBUTIONS

87

P. 153

NONDIVIDEND DISTRIBUTIONS

- **No Accumulated Earnings & Profits** → tax treatment depends on shareholder's stock basis
- Distributions ≤ adjusted stock basis → **tax-free**; reduces stock basis
- Distributions > adjusted stock basis → **capital gain** from deemed sale of stock
- **Debt basis is not considered** when determining taxability of a distribution
- Reported on Schedule K-1 Box 16 Code "D"

88

EXAMPLES: P 153 & 154

Example 4.24: Non-taxable Distribution

- *Sufficient Basis*

Example 4.25: Taxable Distribution

- Insufficient Basis

89

CROSS-REFERENCE: DIVIDEND DISTRIBUTIONS

P. 154

An S Corp that was previously a C Corp (or acquired assets from one in a reorganization)

Positive AE & P at time of S Election

THE DISTRIBUTION OUT OF AE & P = TAXABLE DIVIDEND

See **pages 130-132** in the ***2020 National Income Tax Workbook***

90

DISTRIBUTION OF APPRECIATED PROPERTY

P. 154

- S corporation must recognize gain on distribution of appreciated property
  - *DEEMED SALE @ FMVV*
- If distributed property is subject to a liability, deemed FMV is reduced by the assumed liability (but not below the liability amount)
- Any gain recognized by S Corp flows through to shareholders
  - *Increasing shareholder basis*
  - *Not taxable unless it exceeds basis*
- **Unless subject to Built-In-Gains Tax**

91

CROSS-REFERENCE: BUILT-IN GAINS TAX (BIG)

P. 154

- Corporate-level tax on S corporations with C Corporation history
- 5-year holding period after S Election
- Flat rate of **21%** on gain from the sale/deemed sale of assets that appreciated **while in a C corp**
- Does not apply if corporation has always been an S corp
- *See* **pages 141-146** in ***2020 National Income Tax Workbook***

92

P. 155

DISTRIBUTION OF LOSS PROPERTY

- No loss recognized by the S Corp on a distribution of loss property
- Shareholder's basis = FMV of property – any liabilities assumed
- **Exception**: I.R.C. § 336 permits loss recognition on a **pro rata distribution** to a qualified person in **complete liquidation** of the corporation

93

P. 155

DISTRIBUTION OF DEPRECIABLE PROPERTY

- I.R.C. § 1239: any gain recognized on property that would be depreciable in the hands of a related buyer must be treated as **ordinary income**
- Related person includes a corporation and any person who owns (actually or constructively) more than 50% of the outstanding stock

94

EXAMPLE 4.26: DISTRIBUTION OF NONCASH PROPERTY

PP. 155-156

- Global Traders, Inc.
- Sofija (40%), Elsa (35%), Peter (25%) – unrelated
- Global Traders had $350,000 Taxable Income
- Global made the following distributions:

Shareholder	Asset	FMV	Adj. Basis	Gain Recognized
Sofija	**Cash**	$200,000	$200,000	$0
Elsa	**Building**	$255,000	$85,000	$170,000
Peter	**Securities**	$125,000	$190,000	$0

95

EXAMPLE 4.26: DISTRIBUTION OF NONCASH PROPERTY

PP. 155-156

Global Traders' total 2026 taxable income: **$520,000**

- *(taxable income $350,000 + $170,000 gain from distributions)*

Allocated Taxable Income:

- *Sofija: $208,000 ($520,000 x 40%)*
- *Elsa: $182,000 ($520,000 x 35%)*
- *Peter: $130,000 ($520,000 x 25%)*

Each shareholder takes his/her share of income to increase basis and then reduces the basis by the FMV of the distributed property

96

EXAMPLE 4.26: DISTRIBUTION OF NONCASH PROPERTY

PP. 155-156

- Global Traders, Inc.'s Shareholder's Stock Bases Adjustments
- Elsa's basis before distribution less than distribution amount → **$38,000 gain**

	Sofija	Elsa	Peter
Beginning basis	$40,000	$35,000	$25,000
Increase for current-year-income	$208,000	$182,000	$130,000
Basis before distribution	$248,000	$217,000	$155,000
Distribution	($200,000)	($255,000)	($125,000)
Ending Basis	**$48,000**	**$0**	**$30,000**

97

P. 157

AMATEUR SPORTS ORGANIZATIONS

98

P. 157

AMATEUR SPORTS ORGANIZATIONS

Three paths to tax-exempt status:

- ***Educational***: *teaches sports to youth or affiliated with an exempt educational organization*
- ***Charitable***: *combats juvenile delinquency; lessens burdens of government; lessens neighborhood tensions/discrimination*
- ***Foster national or international amateur sports competition***

99

P. 157

EDUCATIONAL ORGANIZATION

"**Educational**" means instruction or training of the individual for the purpose of improving or developing his/her capabilities

- *Instruction on the rules and fundamentals (e.g.,* ***clinics, classes, seminars****) to improve members' skills,* ***may be educational***

Rev. Rul. 77-365: Nonprofit conducted clinics, workshops, lessons, and seminars to instruct and educate individuals in a particular sport → organizations operated exclusively for educational purposes qualify

100

P. 158

CHARITABLE ORGANIZATION

Charitable organizations include those that:

- *Combat juvenile delinquency*
- *Lessen the burdens of government*
- *Lessen neighborhood tensions*
- *Eliminate prejudice and discrimination*

Rev. Rul. 80-215: Nonprofit developed, promoted, and governed a sport for persons under age 18

- Ruling found that by developing, promoting, and regulating a sport for individuals under age 18, the organization provided an outlet for young people and combatted juvenile delinquency

101

P. 159

AMATEUR SPORTS ORGANIZATIONS

Ways to obtain tax-exempt status:

- ***§ 501(c)(3)*** → *foster national or international amateur sports competition (**but only if no part of its activities involves providing athletic facilities or equipment**)*
- ***§ 501(j)*** → *provides that **Qualified Amateur Sports Organizations (QASOs)** are exempt from § 501(c)(3)'s prohibition of providing athletic facilities or equipment*

102

QUALIFIED AMATEUR SPORTS ORGANIZATIONS (QASOS): DEFINED

P. 159

Any organization organized and operated **exclusively** to foster national or international amateur sports competition if such organization is also organized and operated primarily to conduct national or international competition in sports or to support and develop amateur athletes for national or international competition in such sports

103

TYPICAL ACTIVITIES OF AMATEUR ATHLETIC ORGANIZATIONS

P. 159

- Promulgation of official rules and standards of play
- Chartering and supervision of teams
- Provision of coaching, equipment, and facilities
- Organization of inter-team competition
- Promotion and advertisement of a sport

104

NATIONAL OR INTERNATIONAL SPORTS COMPETITION

PP. 159-160

- *Is the sport an Olympic or Pan-American Games event?*
- *Are the athletes in the age group from which Olympic-quality athletes are usually chosen?*
- *Are the athletes serious contenders for Olympic or Pan-American Games?*
- *Must athletes demonstrate a level of talent and achievement to receive organizational support?*

105

NATIONAL OR INTERNATIONAL SPORTS COMPETITION

PP. 159-160

- *Does the organization provide intensive, daily training (rather than open weekend events)?*
- *Is the organization focused on improving a small group of outstanding athletes (rather than improving public health generally)?*
- *Is the organization a member of the United States Olympic Committee?*

106

P. 160

APPLICATION FOR EXEMPTION

Apply for tax exempt status by filing:

- ***Form 1023; or***
- ***Form 1023-EZ***

107

P. 160

FORM 1023-EZ

Organization may file Form 1023-EZ if they meet both:

- ***Gross receipts test****: ≤ $50,000 in annual gross receipts in the current year and the next 2 years* ***and*** *cannot have exceeded $50,000 in any of the prior 3 years*
- ***Asset test****: total FMV of assets ≤ $250,000*
  - Total assets include cash, receivables, inventory, investments, depreciable assets, land, buildings, equipment, and all other assets

Organizations must complete Form 1023-EZ Eligibility Worksheet

108

HOW AND WHEN TO FILE

P. 163

Form 1023 & Form 1023-EZ must be filed electronically at Pay.gov (no paper applications accepted)

User fees: Form 1023 = $600; Form 1023-EZ = $275

If filed within **27 months** of the end of the month of legal formation → effective date of exemption is the legal date of formation

If filed more than 27 months after formation → effective date is filing date

- Late filers may request an earlier effective date on Schedule E (Form 1023) if they acted reasonably, in good faith, and granting relief will not prejudice the government

109

P. 165

LABOR ORGANIZATIONS

110

DEFINITION OF LABOR ORGANIZATION

P. 165

Tax-exempt status under § 501(c)(5)

An association of workers who have combined to protect or promote the interests of the members by bargaining collectively with their employers to secure better working conditions, wages, and similar benefits

Two requirements for exemption:

- *Net earnings may not inure to the benefit of any member*
- *Objects of organization must be the* ***betterment of conditions*** *of those engaged in labor and the development of a* ***higher degree of efficiency*** *in their respective occupations*

111

P. 166

QUALIFYING ACTIVITIES

Rev. Rul. 76-31: Teachers' organization qualified as a labor organization by:

- *Sponsoring seminars and courses for members*
- *Participating in state and national conventions of teachers*
- *Bargaining collectively on behalf of members*
- *Processing grievances pursuant to a labor contract with the local school board*
- *Sending monthly newsletters and conducting regular meetings*

Activities improved labor conditions, developed higher efficiency in teaching, and kept members informed → qualified as a labor organization

112

APPLICATION FOR EXEMPTION: FORM 1024

P. 166

Organizations are required to file Form 1024 to apply for recognition of exemption under § 501(c)(5)

Filing Form 1024 provides the organization with an **IRS determination letter**

Benefits of a determination letter:

- *Public recognition of tax-exempt status*
- *Possible exemption from certain state taxes*
- *Nonprofit mailing privileges*
- *Eligibility for grants*

113

P. 166

FILING REQUIREMENTS

Form 1024 submitted electronically through **Pay.gov**; a user fee applies

Annual return or notice requirements are the same as for § 501(c)(3) organization

114

P. 166

PRACTITIONER NOTE: DEDUCTIONS

- Contributions are generally **not deductible as charitable contributions**
- May be deductible as **trade or business expenses** if ordinary and necessary in the conduct of the taxpayer's trade or business

115

QUESTIONS?????

116