

# *IRS guidance addresses treatment of disallowed losses associated with certain S corporation distributions*

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## *In brief*

In a recent Chief Counsel Advice memorandum (CCA 201421015), the IRS concluded that S corporation losses disallowed under Section 311(a) reduce both the shareholders' basis in the S corporation stock and the S corporation's accumulated adjustments account (AAA). S corporations contemplating a distribution of loss property should consider the impact of the IRS's conclusion.

## *In detail*

### ***Facts and issues***

In the CCA, the taxpayer, an S corporation, transferred title of loss property (i.e., property with an adjusted tax basis greater than its fair market value on the date of transfer) to a partnership owned by its shareholders in the same proportion. For federal income tax purposes, the taxpayer reported this transaction as a distribution of property (not in complete liquidation) directly to its shareholders, followed by their contribution of the property to the partnership. The S corporation's loss on the distribution was disallowed under Section 311(a), but the shareholders did not reduce their basis in the taxpayer's stock and the taxpayer did not reduce its

AAA by the unrecognized loss.

The CCA addresses whether the shareholders' stock basis and the taxpayer's AAA should have been reduced by the disallowed loss.

### ***Analysis***

#### ***Background on shareholder stock basis and S corporation AAA***

A shareholder's basis in S corporation stock and an S corporation's AAA are maintained and increased/decreased by various items to determine, among other things, the federal income tax impact of the S corporation's distributions.

Section 1367(a)(2)(D) provides that a shareholder's basis in S corporation stock is decreased by, among other

things, expenses of the corporation that are not deductible in computing its taxable income and are not properly chargeable to capital. Reg. sec. 1.1367-1(c)(2) explains that for purposes of Section 1367(a)(2)(D), such noncapital, nondeductible expenses include only those items for which no loss or deduction is allowable and not items for which the deduction is merely deferred to a later tax year. Similarly, Reg. sec. 1.1368-2(a)(3) explains that an S corporation's AAA generally must be decreased by noncapital, nondeductible expenses.

#### ***Are Section 311(a) losses noncapital, nondeductible expenses?***

Section 311(a) of subchapter C generally provides that a

corporation does not recognize gain or loss upon a non-liquidating distribution of property or its stock made with respect to its stock. Under Section 1371(a), the provisions of subchapter C generally apply to S corporations and their shareholders unless applying the rules would be inconsistent with subchapter S. The IRS noted that Section 311(a) is consistent with subchapter S and therefore applies to S corporations.

Although Reg. sec. 1.1367-1(c)(2) provides several examples of noncapital, nondeductible expenses—including meal and entertainment expenses disallowed under Section 274 and fines and penalties disallowed under Section 162(f)—losses disallowed under Section 311(a) are not explicitly listed. The IRS, however, cited several treatises that state that such losses should reduce a shareholder's stock basis and an S corporation's AAA. It also analogized to the investment adjustment rules under the consolidated return regulations. Those rules provide that losses disallowed under Section 311(a) are noncapital, nondeductible expenses for purposes of reducing a member's basis in its subsidiary's stock (Reg. secs. 1.1502-32(b)(3)(iii)(A) and 1.1502-13(f)(7), Example 1(d)).

Finally, the IRS suggested that the failure to reduce a shareholder's basis in S corporation stock and an S corporation's AAA by a loss disallowed under Section 311(a) effectively could convert what is intended to be a permanent disallowance into a deductible item in the future (e.g., upon the S corporation's liquidation or upon the sale of the S corporation's stock). The IRS provided an example to illustrate this point:

**Example:** Shareholder forms S Corp in Year 1 by contributing Asset A with a fair market value of \$1,000.

Shareholder has \$1,000 of basis in his stock, and S Corp has \$1,000 of basis in Asset A. Over the course of time, Asset A declines in value by \$100, and is now worth \$900. In Year 2, S Corp distributes Asset A (still worth \$900) to Shareholder in a Section 301 distribution. S Corp's \$100 loss on the distribution is disallowed under Section 311(a), and Shareholder reduces his basis in S Corp stock to \$100 and takes Asset A with a basis of \$900 (its fair market value). S Corp later liquidates.

The IRS noted that, if Shareholder is required to reduce his basis in S Corp stock for the \$100 loss disallowed under Section 311(a), his new basis in S Corp would be zero. Upon liquidation, he would receive no proceeds since S Corp has no cash or other assets, and there would be no federal tax impact. On the other hand, if Shareholder is not required to reduce his stock basis by the \$100 disallowed loss, he would have \$100 of basis in his S Corp stock upon liquidation and would recognize a \$100 capital loss. In the latter case, according to the IRS, S Corp's \$100 loss on the distribution of Asset A effectively is deferred rather than permanently disallowed.

### ***The takeaway***

In certain situations, the holding of the CCA could deny S corporation taxpayers a true economic loss. For example, Shareholder forms S Corp by contributing Assets A and B, each with a fair market value and basis of \$500. After the fair market value of B decreases to \$300, S Corp distributes it to Shareholder in a Section 301 distribution. Under the CCA, Shareholder's basis in S Corp stock is reduced by \$500—the \$300 fair market value of Asset B plus the \$200 loss disallowed under Section 311(a). Because Shareholder takes a fair market value basis in Asset B, the

economic loss caused by Asset B's devaluation is lost.

By contrast, in the C corporation context, Shareholder's basis in the stock would be reduced by at most \$300—the fair market value of Asset B, preserving the economic loss in the Shareholder's hands. Given the single level of tax associated with an S corporation, a basis reduction pursuant to the CCA puts the S corporation shareholder in a worse position than a C corporation shareholder. Accordingly, while it is difficult to establish that Section 311(a) is inconsistent with subchapter S (i.e., allowance of a deduction is probably not appropriate), the stock basis reduction proposed by the CCA may not be appropriate from a policy perspective in the fact pattern illustrated above.

Moreover, just a few days before the IRS issued the CCA, the US Court of Appeals for the Third Circuit addressed a related issue. In *Ball v. Commissioner*, 742 F.3d 552 (3d Cir. 2014), the court addressed whether the deemed liquidation arising from a Qsub election resulted in an item of income that increased the shareholders' basis in the S corporation under Section 1367(a). The shareholders argued that, even though no gain was *recognized* on the liquidation under Section 332, gain had been *realized* under Sections 61(a)(3), 331, and 1001 and that the realized gain should increase their stock basis. The court rejected the argument, holding that the deemed liquidation was governed solely by Section 332 and that the unrecognized gain did not constitute an item of income for Section 1367(a) purposes.

Following the logic of the *Ball* case (i.e., that unrecognized gain does not impact S corporation stock basis), loss not recognized under Section 311(a) should similarly have no impact on S

corporation stock basis or AAA. Given how close in time they were issued, the CCA does not address the *Ball* case; however, future guidance

hopefully will shed further light on the IRS's view. In the meantime, S corporations should be aware of the potential pitfalls of distributing loss

property and should consider potential alternatives to preserve those losses.

## ***Let's talk***

For a deeper discussion of how this issue might affect your business, please contact the PwC professional listed below or your local [PCS contact](#).

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