

## Form 7203: S-Corporation Shareholder Stock and Debt Basis Limitations

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Form 7203 and its separate instructions are developed to replace the 3-part Worksheet for figuring a Shareholder's Stock and Debt Basis and its related instructions formerly found in the Shareholder's Instructions for Schedule K-1, Form 1120-S.

### Shareholder's Responsibilities

It has always been the duty of each shareholder to keep track of their individual stock and loan basis per IRS schedule K-1 instructions. However, as all of you are aware that work with us, these calculations have always been provided by Marnell Financial. I personally, Dino A. Marnell, have been doing basis schedules since my first tax season working on 1993 taxes. This has been a major area of concern for the IRS, and this was the main reason why they completely overhauled Schedule K-1 (at least 10-15 years ago) with much more sophisticated reporting. These enhancements will keep coming as laws continue to change year-over-year.

### Why are basis schedules so important?

- We calculate your year-end stock basis.
- We calculate your year-end loan basis.
- We calculate **tax treatment of loan repayments**.
- We calculate the **amount of the s-corporation loss the shareholder is allowed** on their personal return.
- We calculate loss carryforwards (**known as**) **suspended losses**.

**Note – Without ending basis in your stock or loan or both, losses are disallowed at the shareholder level and are suspended which means they can't be deducted in the current year.** The IRS is growing impatient because there are many tax preparers (**not us**) and self-prepared returns that continue knowingly or unknowingly to take losses on their personal returns that aren't allowed. Many tax firms don't even understand how to do the basis schedules, so they don't prepare them. When we get other K-1's from our clients that we didn't prepare that don't have basis schedules attached we can't take the losses without going back and trying to re-create the basis with our clients. At times this can be a major issue to re-create when the accountant in charge wasn't keeping adequate records and the shareholders don't have them or understand the process.

### Why is what I am saying so important now?

The preparation of Form 7203 is mandatory and must be filed by s-corporation shareholders who:

- Want to claim a deduction for an s-corporation loss.
- Received a non-dividend distribution from an s-corporation. (**These are for all of our clients, and we call them distributions for short when we talk/email with you**).
- Disposed of s-corporation stock.
- Received a loan repayment from an s-corporation.

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### What's basis in layman's terms?

- It is the amount of skin the taxpayer has in the game. In other words, what you are personally at risk for losing.
- There are two different ways to get basis, which are:
  - Stock basis.
  - Loan basis.
  - And they must be tracked separately.

### Stock Basis

- We will not spend a lot of time defining stock basis. At the very least, it starts with how much you capitalized your corporation with, which in many small businesses is usually \$1,000.
- It will increase by additional stock purchases, separately stated items of income, non-separately stated items of income, tax-exempt income, etc.
- It will decrease by distributions of cash or property to the shareholders, separately stated losses and deductions, non-separately stated losses, nondeductible corporation expenses, etc.
- You basis can never go below zero (this is what creates the suspended losses). However, if you take distributions in excess of your basis, they will become a taxable event, which can either be a short or long-term capital gain based on your holding period of the stock.

### Loan Basis

- This is established when a shareholder loans money to the s-corporation directly.
- Note – Loan guarantees on business loans do not increase loan basis. The courts have consistently held that the mere guarantee of a loan does not increase basis in the s-corporation, despite the guarantor's liability. You can only get basis, when you actually step in the shoes of a corporation and pay the business debt with your personal funds. Hence, making another direct shareholder loan to the business.
- What's a shareholder loan?
  - A shareholder loan is money lent to the s-corporation by a shareholder that is formalized by a written document (called a formal note). These must be separately tracked.
  - Loans that are made to the s-corporation that aren't evidence by a written instrument are referred to as an (open account debt). These loans aren't separately tracked. **(These are the type of loans that most of our clients have on account).**
    - 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.
    - Advances and repayments made during the s-corporation's tax year on an open account are netted at the close of the s-corporations tax year (12/31) for calendar year taxpayers to determine the amount of any net advance or net repayment.

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(For our clients that we do a formal review of their accounting for taxes, we always close out distributions against your open account loans on an annual basis. Note – we are doing this to try to get these loans off of the books as soon as possible – this will be explained later).

### Can your loan balance be different from your loan basis?

- Answer is “YES”.
- How can this happen? Let’s assume that I borrowed my corporation \$100,000 this year. Let’s also assume that I have \$1,000 of stock basis. Also, let’s assume, I have a separately stated business loss on my K-1 of \$51,000. The results of this transaction would be as follows: I first reduce my stock basis by \$1,000 to zero and then reduce my loan basis by \$50,000. In other words, my total basis was \$101,000 (stock + loan) and I lost \$51,000, so my remaining basis is \$50,000, which is all loan basis and no stock basis.
- In this scenario, I would have a loan basis of \$50,000 at the end of the year, but my corporation would still owe me \$100,000, which is my loan balance/face value of my loan to the corporation.
- If we start repaying the loan balance back to the shareholder, and the basis remained at 50% of the face value then each payment I make to myself would be 50% taxable and 50% would be non-taxable. This is extremely important to understand as you can pay tax on your loan repayments in certain situations.

### Why am I spending all this time on this memo?

- [https://www.irs.gov/pub/irs-access/f7203\\_accessible.pdf](https://www.irs.gov/pub/irs-access/f7203_accessible.pdf)
- Please open the above IRS link to Form 7203.
- Note – here is the issue as we must now keep track of stock and loan basis on this form. Moreover, each formal note must be separately tracked, and we used to be able to aggregate on our basis schedules. All open account debt (without a written instrument) must be dealt with and can be aggregated, but can become a formal note once it exceeds \$25,000 as of January 1<sup>st</sup> of the following year.
- Moreover, the guidance, draft forms and draft instructions are still pending. Per the K-1 instructions it is unclear if we will be able to use this form at the entity level. It absolutely must be filed with your personal tax return when you take losses, receive distributions and/or loan repayments of debt, or disposed of your stock.
- If there is no way to report this information at the entity level, how do the shareholder’s get this information from us or their business accountants, so they can file this form on their personal taxes? This is a key area of concern and there is still no information from the IRS and our software providers aren’t ready to execute changes because there isn’t any guidance.
- Now because of this new reporting requirement, we will really have to enforce compliance on loan repayments to the shareholders as it relates to interest, amortization schedules, and the like.
- In many instances, we will be forced to impute the interest on these notes (both the formal and open account loans) that are over \$10,000 in balance. Imputing interest means the shareholder will pay tax on

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the interest it would have received, but actually never was paid the money from the corporation (because the loan wasn't properly established with an applicable federal interest rate). For a cash basis taxpayer, you will have the pleasure of paying income tax on phantom imputed interest income and not being able to take a business deduction because the company never paid the interest.

- This will require us to make recommendations and changes in your loan repayments on the books and tax returns.
- Open account loans under \$10,000 are fine and there isn't any requirements to impute interest.
- Open account loans between \$10,000 and \$25,000 can stay open (no written instrument), but we must impute interest. Also, if you have taxable loan repayments under an open account loan they are taxed as ordinary income which isn't a tax benefit to you, which means we might have to make them a formal note.
- Any open account loan that exceeds \$25,000 at the end of the year will become a formal note. If you have other formal notes, each will be separately stated and tracked. Moreover, if we aren't paying interest on these formal loans, we will have more imputed interest to deal with and then must establish a formal repayment plan, using promissory notes, amortizations schedules, etc.
- As you can see there are many more complications to our s-corporations shareholders that have loan basis, different loans values, open account debt, and formal notes. This is all being done to make sure shareholders aren't taken losses that exceed their basis, that they are paying taxes on excess distributions, and finally are paying either ordinary income (open account) or capital gain (formal note) on loan repayments when the loan balance and loan basis aren't equal.

### Closing Remarks

- To say the least, we aren't very excited about these changes and how complicated these news laws are becoming for small business owners or taxpayers that have a passive interest in a business. If you are one of our individual clients and you get K-1's from other accountants and no information is sent to you, we will have to provide this memo to you and guide you through the process. This is a substantial undertaking and is completely unnecessary in our viewpoint as we have always complied with completing shareholder stock and loan basis schedules. This is being done as a way to force compliance on all the firms and self-preparers that are not in compliance with the laws.
- Remember, we will be here for you and will always do our best to make sure you understand the process and how to make reasonable adjustments, come up with methods to cure issues of the past and hopefully find a way to efficiently get this work done at the entity and shareholder level.
  - Kindly take into consideration, that we have no guidance are in a holding pattern. Even if we were able to finish a business return with the old shareholder basis schedules and they reported losses, we couldn't file your personal return because we have no guidance on this form, and it is still in draft format. The loss can't be taken on the tax return without completion of this form.