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# Do Certain Excess S Corporation Expenses Carry Over?

After increasing stock basis by their pro rata shares of income items, shareholders of an S corporation must reduce stock basis by their pro rata shares of three tiers of items. If a shareholder elects to shift the order of Tier 2 and 3 items when reducing the stock basis, any Tier 2 items in excess of the shareholder's basis are carried over. If that election isn't made, the Code strongly suggests there is no carryover of Tier 2 items.

**I**nternal Revenue Code §1366(a) provides that shareholders of an S corporation must take into account their pro rata shares of (1) the corporation's separately stated items of income (including tax-exempt income), loss, deduction, or credit and (2) the corporation's nonseparately computed income or loss. The character of each item also passes through to the shareholders pursuant to §1366(b). If the aggregate amount of deductions and losses allocated to a shareholder under §1366(a) exceeds the sum of that shareholder's basis in corporate stock and basis in corporate indebtedness (outside basis), however, §1366(d)(1) prevents the excess from being taken into account by the shareholder. Section 1366(d)(2) provides that any loss or deduction that is disallowed *by reason of*

§1366(d)(1) is carried over.

Section 1367(a) provides rules for the adjustments to a shareholder's stock basis. As a general rule, stock basis is increased first by items of income (including tax-exempt income), any nonseparately computed income, and by certain non-oil and gas depletion. Next, under Reg. §1.1367-1(f), stock basis is decreased by the following items in order:

1. Distributions that aren't includable in shareholder income by reason of §1368 (Tier 1 items).
2. Noncapital, nondeductible expenses (NNEs) and the shareholder's depletion deduction for any oil and gas property held by the S corporation to the extent the deduction doesn't exceed the shareholder's proportionate share of the property's adjusted basis (Tier 2 items).
3. Items of loss or deduction and any nonseparately computed loss (Tier 3 items).

Examples of NNEs include the disallowed portion of meals and entertainment expenses under §274, losses disallowed under §267(a)(1), expenses and interest related to tax-exempt income

under §265, and fines and penalties not deductible under §162(f). An interesting illustration is provided in the following example:

### *Example 1*

Joe is an individual who owns 100% of the stock of WidgetCo, an S corporation. WidgetCo forms a new corporation, Newco, and drops assets with a basis of \$150 and value of \$100 into Newco in exchange for 100% of Newco stock. Without regard to §362(e)(2), Newco would have a \$150 basis in the assets, and WidgetCo would have a \$150 basis in Newco stock. Under §362(e)(2), Newco's basis in the assets is reduced by \$50 to \$100, unless both WidgetCo and Newco elect to reduce WidgetCo's basis in Newco stock by \$50 to \$100. Assume the election is made. Under Prop. Reg. §1.362-4(c)(7), the \$50 reduction to Newco stock basis is treated as an NNE of WidgetCo.

### **Reg. §1.1367-1(g) Election**

The above-stated ordering rule may be disadvantageous to taxpayers and their advisors.

### *Example 2*

Sally is an individual who owns

100% of GizmoCo, an S corporation. Sally's basis in her GizmoCo stock is \$100. There's no debt from GizmoCo to Sally. During the current year, GizmoCo has a nonseparately computed loss of \$100 and an NNE of \$100. Under the ordering rule, the \$100 NNE reduces Sally's stock basis by \$100 to \$0. Thus under §1366(d)(1), the nonseparately computed loss of \$100 can't be used by Sally during the current year and instead must be carried forward under §1366(d)(2).

The good news is that Sally may irrevocably elect under Reg. §1.1367-1(g) to change this ordering rule so that Tier 3 items are taken into account before Tier 2 items.

### Example 3

The facts are the same as in Example 2 except that Sally has made a Reg. §1.1367-1(g) election. In this event, the \$100 nonseparately computed loss flows through to Sally (good news for her), reducing her stock basis in GizmoCo to \$0. The bad news is that the election requires that the \$100 NNE be carried over to the next taxable year.

Let's look at another example where no Reg. §1.1367-1(g) election is in effect.

### Example 4

The facts are the same as in Example 2 except that GizmoCo's NNE is \$110 (instead of \$100). Sally hasn't made the Reg. §1.1367-1(g) election. Under the ordering rule, \$100 of the NNE reduces Sally's stock basis in GizmoCo to \$0. The \$100 of nonseparately computed loss is clearly carried over under

§1366(d)(2). So what happens to the extra \$10 (\$110-\$100) of NNE?

A plain reading of the §1366(d)(2)(A) carryover rule strongly suggests that the \$10 of excess NNE in Example 4 isn't carried over to the succeeding taxable year; it simply disappears. Section 1366(d)(2) carries over only those items that are disallowed by reason of §1366(d)(1) (i.e., losses and deductions disallowed because they exceed the shareholder's outside basis). NNEs aren't deductible, of course, but not *by reason of* §1366(d)(1). Thus, the indefinite carryover rule of §1366(d)(2) simply doesn't apply to NNEs. (As explained earlier, a carryover of Tier 2 items may occur if a Reg. §1.1367-1(g) election is in effect.)

Likewise, the other Tier 2 item, oil and gas depletion, shouldn't be carried over under §1366(d)(2) to the extent the depletion exceeds outside basis. Oil and gas depletion isn't a corporate deduction; instead, it's computed separately by each shareholder. [See §1363(b)(2), §703(a)(2)(F), and §613A(c)(11).] Because it isn't a corporate deduction, §1366(a)(1) literally doesn't apply to it, which means that §1366(d)(1) by its terms doesn't apply, which in turn means that §1366(d)(2) (the carryover provision) by its terms doesn't apply.

### Shifting the Order

After increasing stock basis by their pro rata shares of income items, shareholders of an S corporation must reduce stock basis by their pro rata shares of the following tiers of items, in order: (1) distributions; (2) noncapital,

nondeductible expenses and oil and gas depletion; and (3) loss and deduction items. A shareholder may elect to shift the ordering of Tier 2 and Tier 3 items, but that election comes at a price—any Tier 2 items in excess of the shareholder's outside basis is carried over. If the election isn't made, the Code strongly suggests that there is no carryover of the Tier 2 items. **SF**

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