Current Federal Tax Developments

Week of June 6, 2022

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CURRENT FEDERAL TAX DEVELOPMENTS
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SECTION 174
AICPA LETTER GIVES RECOMMENDATION ON GUIDANCE ON UPCOMING TCJA REQUIREMENT TO AMORTIZE RATHER THAN EXPENSE R&D EXPENSES

Source: "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, 5/26/22

The AICPA sent a letter[1] to IRS Associate Chief Counsel Holly Porter (Passthroughs and Special Industries) with comments regarding the need for guidance on research and experimental expenditures under IRC §174.

The Tax Cuts and Jobs Act revised IRC §174 so that, effective for tax years beginning after December 31, 2021, *specified research or experimental expenditures* are no longer currently deductible by a business, but rather must be amortized over 5 years for domestic research and 15 years for foreign research.

Stalled Attempt to Restore the Full Expensing of Such Costs

One of the regular budget games Congress has played over the years is to enact revenue raisers as part of major bills, but provide these likely unpopular revenue raising provisions won't take effect for many years. In the case of the Affordable Care Act, for example, the "Cadillac tax" on high cost medical plans was not scheduled to take effect until many years after the 2010 passage of the law.

An unstated assumption for such long delayed revenue raisers is that a later Congress will repeal the provision before it actually takes effect and begins to inflict pain. In the case of the Affordable Care Act, this implied agreement with future Congresses did eventually play out—that tax was never actually implemented.

This has the advantage of initially making the provisions in the original bill appear to have less of an overall impact on net federal spending. As the pain does not take place for years, there is less of a hue and cry about including this provision in lieu of making actual reductions in the cost of the package.

[1] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022, https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-aicpa-comment-letter-section-174-research-and-experimental-expenditures-final.pdf (retrieved June 3, 2022)

Then, years later, Congress can remove the provision once the only issue before the Congress is the pain this provision will create—a current pain that makes it easier to explain the need to incur the budget hit. Who knows, it might even help get those same Congressional members who voted for the first bill to now even get more credit for preventing these harms.

However, things aren't going so well for this provision that raised revenue by forcing companies to capitalize and amortize research or experimental expenditures in what seemed at the time the "distant" future. The expected repeal has been introduced, but it was part of the Build Back Better Act which has stalled in Congress. For now, backers of the repeal have not been able to attach the provisions to a "must pass" bill, nor have they succeeded in getting both chambers to consider a "clean" bill.

In the interim, C corporations looking to prepare GAAP financial statements have been forced to start trying to figure out how the law would impact their tax provisions. As well, while it seems more likely than not that Congress will eventually restore immediate expensing (albeit, potentially retroactively sometime in 2023), that cannot be guaranteed if Congress deadlocks—the repeal could become a victim of partisan battles in Congress even if clear majority on both sides of the aisle claim passing this provision is a high priority.

The Post-TCJA IRC §174

The new IRC §174 begins with the following general rule:

> (a) In general. In the case of a taxpayer's specified research or experimental expenditures for any taxable year —
>
> > (1) except as provided in paragraph (2), no deduction shall be allowed for such expenditures, and
> >
> > (2) the taxpayer shall —
> >
> > > (A) charge such expenditures to capital account, and
> > >
> > > (B) be allowed an amortization deduction of such expenditures ratably over the 5-year period (15-year period in the case of any specified research or experimental expenditures which are attributable to foreign research (within the meaning of section 41(d)(4)(F))) beginning with the midpoint of the taxable year in which such expenditures are paid or incurred.[2]

[2] IRC §174(a)

IRC §174(b) defines what are *specified research or experimental expenditures*, which is key to applying this provision:

> (b) Specified research or experimental expenditures. For purposes of this section, the term "specified research or experimental expenditures" means, with respect to any taxable year, research or experimental expenditures which are paid or incurred by the taxpayer during such taxable year in connection with the taxpayer's trade or business.[3]

Scope of the Guidance the AICPA is Requesting

The letter outlines those areas where the AICPA believes guidance is needed in the very near future. The letter reads:

> Specifically, the AICPA requests guidance and provides recommendations in the following areas.
>
> 1. Identification of categories of section 174(a) expenditures.
>
>   - Treasury and IRS should issue regulations providing that section 174(a) expenditures include direct costs, including employee compensation, contract labor, and materials, and, at the taxpayer's election, allocable indirect and overhead costs.
>
>   - Additionally, Treasury and IRS should issue regulations that illustrate, using detailed examples, which costs are "incident to" the development or improvement of a product as per Reg. § 1.174-2.
>
> 2. Issues that have arisen with regard to Rev. Proc. 2000-50.
>
>   - IRS should modify the scope limitation under section 4 of Rev. Proc. 2000-50 to clarify that the limitation on costs that a taxpayer has treated as R&E expenditures under section 174 only applies to costs previously subject to an irrevocable election under section 174, including section 174(b) or charging the expenses to capital account.

[3] IRC §174(b)

- Additionally, IRS should make a corresponding modification to the scope limitation under section 9.01(2) of Rev. Proc. 2022-14.[4]

The AICPA describes the background that leads to the need for this updated guidance:

> Pre-TCJA, section 174 provided taxpayers with the option to immediately expense R&E expenditures under section 174(a) or elect to defer and amortize the expenditures over a period of not less than 60 months under section 174(b), or charge the expenditures to capital account under Reg. § 1.174-1. In addition, taxpayers could elect under section 59(e) to amortize over 10 years expenditures otherwise allowed as a deduction under section 174(a). Prior to the changes, taxpayers that paid or incurred costs for software development could rely on Rev. Proc. 2000-50, which allowed taxpayers to treat software development costs in the same manner as under section 174, including the same options (other than charging to capital account), whether the expenditures met the requirements of section 174 or not.
>
> In addition to mandatory capitalization of R&E expenditures, the TCJA changed the language in section 174 from "research or experimental expenditures" to "specified research or experimental expenditures," and added a special rule under section 174(c)(3) that specifies that for purposes of section 174, any amount paid or incurred in connection with the development of any software is treated as a "specified research or experimental expenditure." As a result, the TCJA effectively eliminates taxpayers' ability to rely on Rev. Proc. 2000-50 to deduct software development expenditures in the year incurred.[5]

The AICPA breaks the letter down into two sections, the first looking for overall guidance on what constitutes various §174(a) expenditures and the second dealing with issues related to software expenditures arising due to Revenue Procedure 2000-50 and the post-TCJA IRC §174.

Identification of Categories of IRC §174(a) Expenditures

The AICPA begins by noting that a large number of taxpayers have no systems in place to identify research or experimental expenditures:

> Many taxpayers that pay or incur section 174 expenditures may not have an established methodology to identify the appropriate amounts

[4] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[5] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

> of these expenditures that are now subject to mandatory amortization because, prior to the TCJA, the tax accounting treatment of current expensing generally would have been allowable whether the expenses were deductible as ordinary and necessary trade or business expenditures under section 162(a) or R&E expenditures under section 174(a).[6]

An initial reaction some might have is that, wait a minute, a lot has been written about the IRC §41 research credit and can't that serve to provide guidance. But the AICPA notes that while the §174 definitions are relevant to the research credit, more expenses are treated as §174 expenses than are those that can be used for IRC §41's research credit:

> Taxpayers with research activities conducted in the United States may claim a research credit under section 41 for increasing these activities. The amount of the section 41 research credit by statute is a function of several variables including the amount of expenditures paid or incurred by the taxpayer that meet the definition of section 174(a) expenses. Although meeting the definition of section 174 is generally considered a threshold requirement for the section 41 research credit, the pool of costs eligible for the credit has been clearly delineated to include only wages, supplies, rental or lease of computers, and contract research expenses.[7]

The letter goes on to discuss the limitations of the regulations under IRC §174:

> In contrast to the requirements for the section 41 research credit, the regulations under Reg. § 1.174-2 do not clearly delineate the extent to which various categories of expenses, including direct and indirect costs, fall within the definition of research and experimental expenditures. Rather, the regulations focus on the nature of the activity to which the expenditures relate. The regulations further provide that the qualified activities must involve the elimination of uncertainty in the development or improvement of a product, including products to be used by the taxpayer in its trade or business, or held for sale, lease, or license. With respect to defining the categories of expenses that might fall within the scope of section 174, and thus the amortization requirement provided in the TCJA, the regulations provide a very general standard for identifying section 174 expenditures. Pursuant to

[6] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[7] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

> the regulations, section 174 applies to all costs that are "incident to" the development or improvement of a product.
>
> While the regulations do not explicitly define which costs are "incident to" the development or improvement of a product, they do provide that costs paid or incurred in the production of a product after the elimination of uncertainty do not qualify as section 174 expenditures. The regulations exclude certain expenditures from section 174 eligibility including ordinary testing for quality control, management studies, and advertising and promotions, amongst others. Additionally, interpretive guidance suggests that allocable indirect costs and overhead may be section 174 eligible.[8]

The AICPA letter then notes that while previously there was little need for such specific §174 guidance since all expenses were immediately deductible, that is no longer the case:

> Up until the TCJA, due to the current expensing option and the explicit constraints on expenses eligible for the section 41 research credit, there has been far less of a need for detailed rules addressing which categories of costs must be allocated to R&E activities and the extent to which such costs are characterized as expenses subject to section 174 treatment. Indirect costs, including overhead and general and administrative costs are of particular concern for many taxpayers, as such costs may be properly allocable to many business activities. In light of the new mandatory amortization regime, there is a need for guidance that provides taxpayers with certainty and uniformity in the accounting for these costs, and that minimizes controversies over the categories of costs associated with R&E activities that are subject to amortization. Without such guidance, some taxpayers will interpret the rules to apply narrowly to direct costs, while others may apply a full-absorption costing method like the rules of section 263A.[9]

AICPA Recommendations on Section 174(a) Expenditures

The AICPA letter contains the following two recommendations to the IRS and Treasury:

- The AICPA recommends that Treasury and IRS issue regulations providing that section 174(a) expenditures include direct costs, including employee compensation,

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[8] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[9] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

contract labor, and materials, and, at the taxpayer's election, allocable indirect and overhead costs.

- Additionally, the AICPA recommends that Treasury and IRS issue regulations that illustrate, using detailed examples, which costs are "incident to" the development or improvement of a product as per Reg. § 1.174-2.[10]

A key concern of the AICPA relates to how broadly the IRS might cast the net to bring in indirect expenses to be part of the amortization rules. For this reason, the AICPA argues Congress did not intend for §174 to include expenses broadly in the way that IRC §263A brings expenses into inventory:

> In contrast to section 174, the uniform capitalization rules of section 263A provide a requirement to capitalize all direct and indirect costs that directly benefit or are incurred by reason of the production or resale of specified categories of property. In enacting section 263A, Congress provided very detailed rules in the legislative history as to which categories of direct and indirect costs would be subject to capitalization under section 263A. Further, the regulations follow this mandate and provide very detailed rules with a high degree of specificity as to which categories of direct and indirect costs, including overhead and service costs, are required to be allocated to activities and capitalized to property subject to section 263A. The types of activities subject to section 263A are activities for which the capitalization of direct costs, and in some cases certain types of indirect costs, were required to be capitalized under pre-section 263A law. The enactment of section 263A represents a congressional intent to establish more uniform rules for the identification and treatment of indirect costs with respect to tangible property.
>
> Research and experimental expenses were considered a type of indirect cost associated with production of property, but by statute, preserving the current expensing option under section 174(a), this category of costs was explicitly excluded from the capitalization requirement of section 263A.[11]

[10] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[11] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

The AICPA also points out that Treasury did not cast a broad §263A sized net in determining capitalization of intangible assets and benefits in response to the US Supreme Court's *INDOPCO*[12] decision:

> In 2003, in response to controversies that arose from the Supreme Court's 1992 decision in the *INDOPCO* case, the IRS and Treasury issued final regulations to provide certainty as to the capitalization of costs with respect to intangible assets and benefits, including business acquisitions and restructurings. These regulations provide that taxpayers must capitalize amounts paid to acquire or create certain enumerated categories of intangible assets, and costs that facilitate the acquisition or creation of such intangible assets. In contrast to section 263A, these regulations explicitly provide that employee compensation, overhead, and certain de minimis costs are deemed not to facilitate the acquisition or creation of the enumerated intangibles and therefore are not required to be capitalized. Taxpayers may, however, elect to capitalize employee compensation, overhead, and de minimis costs with respect to such intangibles under the regulations.[13]

The letter argues that Congress has not looked to have expansive, full-absorption style costing rules apply to new IRC §174:

> Amended section 174 takes away the option of current expensing under section 174(a). Many, if not most, taxpayers have relied on and consistently used the current expensing method for decades where they have had little need to apply a full-absorption regime. In amending section 174 to eliminate the current expensing option, and mandate amortization for all section 174(a) expenses, including all software development activities, Congress gave no indication that a switch to mandatory amortization should be subjected to a full-absorption regime such as the uniform capitalization regime under section 263A. To the contrary, as evidenced by the need to add a Code section to mandate a full-absorption type regime, it can be inferred that such a regime should be the subject of congressional action rather than administrative mandate. Further, the new mandatory amortization regime mirrors the prior elective amortization option under section 59(e) whereby, to our knowledge and experience relying upon the available guidance, taxpayers availing themselves of that election have never applied a full-absorption regime to allocate additional overhead and general and administrative costs to the pool of costs subject to the election. Similarly, under the former alternative election to either defer and amortize the costs under section 174(b) or charge the expenses to

[12] *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992)

[13] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

> capital account, and which applied to all costs allocable to specific projects, the IRS has never sought to require taxpayers to apply a full-absorption methodology to the project costs subject to these elections. These elections have been in place for almost 70 years without any indication in our practical experience of such a requirement.[14]

The letter then returns to comparing Congress' reasons for enacting IRC §263A as compared to the reasons for enacting IRC §174:

> The legislative history leading up to the enactment of the uniform capitalization rules indicates a perception that congressional action was necessary to mandate full-absorption costing with respect to the various categories of properties subjected to those rules. As evidenced by the statutory language, regulations, and legislative history, imposing such a regime requires detailed and specific rules defining the categories of costs subject to capitalization, the categories of costs not subject to capitalization and methods of allocating costs to the appropriate property or cost objective. Congress gave no indication that in mandating that section 174 expenses be amortized rather than currently expensed, taxpayers would also be subject to a full-absorption costing regime like the one contained in section 263A. Further, given that section 263A treats section 174 expenses themselves as an indirect cost that are not required to be capitalized to property subject to section 263A, it would seem incongruous to then treat section 174 costs themselves as a direct cost that is burdened with indirect costs such as overhead and general and administrative costs. For these reasons, congressional action setting forth a specific requirement and detailed rules is necessary to require that taxpayers apply a full-absorption costing regime for purposes of defining the types and categories of costs that are classified as R&E costs under section 174(a).[15]

Thus, the AICPA concludes, the IRS and Treasury should provide guidance that limits the scope of costs mandated to be amortized under this rule:

> In the absence of such an explicit requirement referencing more detailed rules, guidance should clarify that taxpayers are required to allocate direct costs, including wages, contractor costs, other direct labor costs, and materials and supplies, to the particular costs objective and are not required to allocate indirect costs such as overhead and general and administrative costs to such activity for purposes of

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[14] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[15] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

> identifying the amount of costs required to be amortized under section 174. At the same time, it would also provide a clear reflection of income to permit taxpayers on an elective basis to allocate overhead expenses for this purpose. This election could be patterned after the election Treasury and IRS adopted in 2003 under the intangibles regulations.[16]

Revenue Procedure 2000-50 Issues Under New §174

The second part of the letter deals with Revenue Procedure 2000-50 which provided guidance for software costs under the prior law. The letter begins by summarizing the procedure, as well as the restriction that it only applied to costs not subject to amortization:

> Rev. Proc. 2000-50 provided guidance under prior law for the treatment of costs paid or incurred to develop, purchase, lease, or license computer software, and provides automatic consent for accounting method changes from one optional method to another. However, section 4 of Rev. Proc. 2000-50 explicitly states that this revenue procedure does not apply to any computer software that is subject to amortization as an "amortizable section 197 intangible" as defined in section 197(c) and the regulations thereunder, or to costs that a taxpayer has treated as a research and experimentation expenditure under section 174.[17]

The letter summarizes the provisions of the Revenue Procedure as follows:

> Section 5 of Rev. Proc. 2000-50 provides that the costs of developing computer software (whether or not the particular computer software is patented or copyrighted) in many respects so closely resemble the kind of research and experimental expenditures that fall within the purview of section 174 as to warrant similar accounting treatment. Accordingly, the IRS will not disturb a taxpayer's treatment of costs paid or incurred in developing software for any particular project, either for the taxpayer's own use or to be held by the taxpayer for sale or lease to others, where:
>
> - All of the costs properly attributable to the development of software by the taxpayer are consistently treated as current expenses and deducted in full in accordance with rules similar to those applicable under section 174(a); or

[16] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[17] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

> - All of the costs properly attributable to the development of software by the taxpayer are consistently treated as capital expenditures that are recoverable through deductions for ratable amortization, in accordance with rules similar to those provided by section 174(b) and the regulations thereunder, over a period of 60 months from the date of completion of the development or, in accordance with rules provided in section 167(f)(1) and the regulations thereunder, over 36 months from the date the software is placed in service.
>
> Section 9.01 of Rev. Proc. 2022-14 provides the latest automatic method change procedures for a taxpayer that wants to change its method of accounting for the costs of computer software to a method described in Rev. Proc. 2000-50, including a taxpayer that wants to change its treatment of the costs of developing computer software to one of the methods described above (but only for software development costs incurred in taxable years for which the mandatory amortization rules under section 174 are not in effect). However, section 9.01(2) of Rev. Proc. 2022-14 similarly states that this change does not apply to any computer software that is subject to amortization as an "amortizable section 197 intangible" as defined in section 197(c) and the regulations thereunder, or to costs that a taxpayer has treated as R&E expenditures under section 174.[18]

The letter goes on to describe issues arising regarding the accounting method provisions in this area:

> There has been longstanding uncertainty regarding whether taxpayers were deemed to have historically treated the costs of computer software as R&E expenditures under section 174 that would have precluded such taxpayers from changing their methods of accounting for the costs of computer software under the automatic change procedures of Rev. Proc. 2000-50 and Rev. Proc. 2022-14. In addition, while automatic change procedures are available for a change in the treatment of section 174 costs, a change in accounting method under section 174, must be implemented on a cutoff basis rather than with a section 481(a) adjustment like a change in accounting method under Rev. Proc 2000-50.[19]

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[18] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[19] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

AICPA Requested Change to Scope

The letter requests the following modifications to guidance in this area:

> The AICPA recommends that the IRS modify the scope limitation under section 4 of Rev. Proc. 2000-50 to clarify that the limitation on costs that a taxpayer has treated as R&E expenditures under section 174 only applies to costs previously subject to an irrevocable election under section 174, including section 174(b) or charging the expenses to capital account.
>
> Additionally, the AICPA recommends that the IRS makes a corresponding modification to the scope limitation under section 9.01(2) of Rev. Proc. 2022-14.[20]

The AICPA begins its analysis by looking at the history of Revenue Procedure 2000-50:

> Section 162 allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Similarly, for tax years prior to 2022, section 174(a) allows for immediate expensing of R&E expenditures that are paid or incurred by a taxpayer during the taxable year in connection with its trade or business, although taxpayers may elect under section 174(b) to capitalize and amortize such costs ratably over a period of not less than 60 months. Regulation § 1.174-2(a)(1) defines R&E expenditures under section 174 as expenditures incurred in connection with the taxpayer's trade or business that represent research and development costs in the experimental or laboratory sense.
>
> The IRS published Rev. Proc. 2000-50 to update, modify, and restate the guidelines for the treatment of the costs of computer software. Rev. Proc. 2000-50 provides separate rules for the costs of developing computer software, costs of acquired computer software, and leased or licensed computer software. As mentioned above, the guidance provides three allowable methods of accounting for software development costs (two of which are based on rules similar to those provided by section 174). These options were provided to eliminate controversy and reduce disputes with taxpayers.[21]

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[20] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[21] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

The AICPA describes uncertainty created by this guidance in certain situations:

> The current guidance under Rev. Proc. 2000-50 does not apply to "costs that a taxpayer has treated as R&E expenditures under section 174." However, this specific wording has generated much uncertainty regarding whether certain taxpayers can apply the guidance under Rev. Proc. 2000-50, as illustrated by the following examples:
>
> - Example 1: Taxpayer has historically treated various types of computer software costs (i.e., amounts paid or incurred to develop, purchase, lease, and/or license computer software) as immediate expenses. The taxpayer has now determined a method change is required under Rev. Proc. 2000-50 for the treatment of certain costs (e.g., the purchased software should be capitalized and amortized ratably over a period of 36 months in accordance with section 6.01(2) of Rev. Proc. 2000-50 and section 167(f)(1)).
>
> - Example 2: Taxpayer previously changed its method of accounting for the costs of developing computer software under section 5.01(1) of Rev. Proc. 2000-50 to treat as current expenses *in accordance with rules similar to those applicable under section 174(a)*. The taxpayer has now decided to change its method of accounting for the costs of developing computer software to another method provided under section 5 of Rev. Proc. 2000-50 (e.g., capitalize and amortize ratably over a period of 36 months).[22]

The AICPA looks first at Example 1's facts and issues that arise:

> In example 1, the taxpayer historically treated the computer software costs as immediate expenses. However, has the taxpayer immediately expensed such costs as ordinary and necessary business expenses under section 162 or as R&E costs under section 174? If some of the costs actually meet the requirements of section 174 (e.g., resolving uncertainty) and others do not, would the statement only apply to the former or would it also apply if the taxpayer erroneously treated the expenses as section 174 costs? Based on this statement, could Rev. Proc. 2000-50 also be interpreted to apply only to software development expenses that do not in fact meet the requirements of section 174 (by virtue of the statement that the costs at issue "closely resemble" section 174 expenses, which creates an implication that the procedure might not apply to all software expenses but only the subset

[22] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

of software development expenses that do not in fact meet the requirements of section 174).

It may be impossible to distinguish whether an expense was deducted as an ordinary and necessary business expense under section 162 or as R&E costs under section 174 based on how the costs were reflected on the taxpayer's federal income tax returns, and it would seem to defeat the purpose of Rev. Proc. 2000-50 to scope out of the method change any of the above situations. Furthermore, the guidance under Rev. Proc. 2000-50 was intended to simplify the accounting method treatment of computer software costs without burdening taxpayers from having to undertake an in-depth analysis to determine whether such costs are deductible as R&E expenditures under section 174. The results of such study would be highly subjective anyways given the lack of current guidance under section 174 with respect to computer software costs. In fact, the government previously issued proposed regulations under section 174 in 1983 (47 FR 2790) and 1989 (54 FR 21224) attempting to clarify the treatment of software development costs under section 174 only to withdraw those amendments to the regulations in 1993 (58 FR 15819) and instead lean on the administrative guidance contained in Rev. Proc. 69-21. See below excerpt from the preamble to the 1993 proposed regulations under section 174:

> In Revenue Procedure 69-21, 1969-2 C.B. 303, the IRS announced that, as a matter of administrative practice, it would allow taxpayers to treat software development costs in a manner similar to the manner research or experimental expenditures are treated under section 174. The 1983 proposed regulation, however, would have provided additional conditions on the qualification of software development costs as research or experimental expenditures beyond those applicable to other products.
>
> In the preamble to the 1989 proposed regulation, the IRS announced that it is studying the continuing validity of Rev. Proc. 69-21. The IRS has no present intention of changing its administrative position contained in Rev. Proc. 69-21, but it continues to study its viability. Taxpayers may continue to rely on Rev. Proc. 69-21. The amendments proposed in this document do not provide additional conditions applicable to computer software development costs. The IRS again invites comments on the proper tax accounting treatment of software development costs that do not qualify as research or experimental expenditures.

> The AICPA does not believe it was the IRS' intent to prohibit the taxpayer in example 1 from applying Rev. Proc. 2000-50 based on its present method of accounting. In fact, allowing this taxpayer to apply the guidance in Rev. Proc. 2000-50 would result in greater compliance with the Code. Therefore, the IRS should modify the scope limitations under section 4 of Rev. Proc. 2000-50 and section 9.01(2) of Rev. Proc. 2022-14 to clarify the limitation on costs that a taxpayer has treated as an R&E expenditure under section 174 only applies to costs that have been subject to an irrevocable election under section 174, including section 174(b) or charging the expenses to capital account.[23]

The letter concludes by giving the AICPA analysis of the second example:

> In example 2, the taxpayer's present method of accounting for software development costs is in accordance with section 5.01(1) of Rev. Proc. 2000-50, which is based on "rules similar to those applicable under section 174(a)." This language has led many taxpayers and practitioners to question whether the taxpayer's present method would render them ineligible to make a subsequent change in method of accounting for software development costs under Rev. Proc. 2000-50.
>
> As mentioned above, the guidance under section 5 of Rev. Proc. 2000-50 was provided to eliminate controversy and reduce disputes with taxpayers due to the uncertainty of the extent to which software development costs actually meet the definition of R&E expenditures under section 174. In fact, section 5.01 of Rev. Proc. 2000-50 indicates that the costs of developing computer software "in many respects so closely resemble the kind of R&E expenditures that fall within the purview of section 174 as to warrant similar accounting treatment." Thus, the IRS seems to indicate that certain software development costs are not necessarily R&E costs under section 174 but should be afforded similar treatment. However, this guidance was intended to simplify the accounting method treatment of computer software costs without burdening taxpayers from having to undertake an in-depth analysis to determine which of their software development costs meet the classification criteria of section 174 requirements, and which do not.
>
> The AICPA does not believe it was the IRS' intent to prohibit the taxpayer in example 2 from making a subsequent change in method of

[23] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

accounting for software development costs under Rev. Proc. 2000-50 merely because it presently treats such costs as current expenses.[24]

SECTION 1367 DEALLING WITH MISSING S CORPORATION BASIS FOR NEW CLIENTS

Source: Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," Tax Notes Today Federal, 6/1/22

This week Kristen Parillo published an article in *Tax Notes Today Federal* looking at how the requirement to prepare and attach Form 7203 impacted this tax season that this author was quoted in.[25]

One of the key issues raised in the article was how to deal with new clients who lack basis information on their S corporation investments, either because they had been preparing their own return and had ignored basis rules (perhaps because they had no idea there were such rules) or their prior preparer had ignored the issue.

This article looks at the options that might exist to deal with these situations.

Why the IRS Created Form 7203

The IRS had been requiring S basis computations to be attached to tax returns for many years. The 1997 Schedule E instructions, the oldest version found on the IRS website, had this instruction that was to be used in preparing 1997 returns:

> If you are claiming a deduction for your share of an aggregate loss, attach to your return a computation of the adjusted basis of your corporate stock and of any debt the corporation owes you.[26]

The IRS made the requirement more explicit in 2018, adding a specific box that must be checked indicating if a basis calculation was required to be attached. Presumably the

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[24] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[25] Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," *Tax Notes Today Federal,* June 1, 2022, https://www.taxnotes.com/tax-notes-today-federal/basis/new-basis-reporting-form-spotlights-role-proper-documentation/2022/06/01/7djjp (retrieved June 4, 2022)

[26] 1997 Instructions for Schedule E, Supplemental Income and Loss, p. 5, https://www.irs.gov/pub/irs-prior/i1040se--1997.pdf (retrieved June 4, 2022)

IRS added this because the agency noticed that such basis calculations were often not being attached.

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, excess farm loss, 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 . . . . ☐ **Yes** ☐ **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			☐		☐	☐
B			☐		☐	☐
C			☐		☐	☐
D			☐		☐	☐

Now it appears the IRS has decided that even the check box had not gotten the attention of those filing returns, so the agency created Form 7203 that must be attached to Form 1040 if the taxpayer:

- Is claiming a deduction for their share of an aggregate loss from an S corporation (including an aggregate loss not allowed last year because of basis limitations),
- Received a non-dividend distribution from an S corporation,
- Disposed of stock in an S corporation (whether or not gain is recognized), or
- Received a loan repayment from an S corporation.[27]

[27] Instructions for Form 7203 (12/2021), January 19, 2022, https://www.irs.gov/instructions/i7203#en_US_202112_publink100045402 (retrieved June 4, 2022)

The first page of Form 7203 is reproduced below:

Form **7203**
(December 2021)
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(s) shown on return	**Identifying number**
Name of S corporation	**Employer identification number**

Stock block (see instructions) ►

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)			6	
	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	
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	**Debt 1** ☐ Formal note ☐ Open account debt	**Debt 2** ☐ Formal note ☐ Open account debt	**Debt 3** ☐ Formal note ☐ Open account debt	**Total**
16 Loan balance at the beginning of the corporation's tax year				
17 Additional loans (see instructions)				
18 Loan balance before repayment. Combine 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. Combine lines 18 and 19				

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 56396V Form **7203** (12-2021)

The page contains the full computation of stock basis in Part I and the beginning of the shareholder's basis in debt in Section A of Part II.

The second page of Form 7203 contains the following:

Form 7203 (12-2021) Page **2**

Part II **Shareholder Debt Basis** *(continued)*

Section B—Adjustments to Debt Basis

Description	Debt 1	Debt 2	Debt 3	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. Combine 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

Description	Debt 1	Debt 2	Debt 3	Total
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.** Combine 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					

Form **7203** (12-2021)

Big Deal or Not So Much?

The *Tax Notes Today Federal* article looked at the impact of this form on the past tax season. As the article notes:

> Whether preparing Form 7203 for the first time was a straightforward task or a nightmare for tax professionals seems to depend on the basis tracking history and recordkeeping skills of whoever handled the shareholder's previous tax returns.[28]

[28] Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," *Tax Notes Today Federal,* June 1, 2022

The article quotes a number of tax professionals who have found issues with both returns previously prepared by taxpayers and even those prepared by other tax professionals when taking on a new client.

Taxpayers are ultimately responsible for tracking the basis in their investments. For partnerships and S corporations this requires tracking much more than simply how much the taxpayer paid for his/her interest.

For stock in an S corporation that basis is tracked under rules found at IRC §1367 after the initial basis of the interest is determined at acquisition. This basis number is used for the following purposes:

- Limiting the amount of net losses that may be deducted by the shareholder on their Form 1040
- Determining if any non-dividend distributions received from the S corporation are considered a return of capital or taxable as a capital gain and
- Computing gain or loss on the sale or exchange of the S corporation shares.

S corporation shareholders also have to track basis in any amounts they have loaned to the S corporation. Such debt basis is important as

- A source of basis for deducting losses from the S corporation should stock basis be exhausted or
- Determining the proportion of any principal repayment that is considered taxable gain vs. a return of the debt basis in the loan.

Debt basis cannot be used to convert taxable distributions in excess of stock basis to a nontaxable status. As well, if debt basis is not restored by year end (before taking into account current year losses), *any* repayment of the debt will lead to taxable income based on the ratio of the basis remaining in the debt to the outstanding principal of the debt.

Thus, basis in stock and debt must be referred to in preparing a shareholder's Form 1040 in the following cases:

- The K-1 shows a net loss being passed out to the shareholder for the tax year;
- Prior year losses suspended due to a lack of basis flow into the current year return;
- Distributions (other than tax dividends) are paid to the shareholder during the tax year;
- Any debt from the shareholder to the S corporation is fully or partially repaid during the year; or

- The S corporation interest is sold or exchanged during the year.

Not coincidentally, this list corresponds to the situations where the IRS demands that Form 7203 be attached to the tax return in order to document any of the following positions on the return:

- The losses claimed on the individual return are allowed to be claimed in the year in question;
- Some or all distributions are not taxable to the shareholder as a gain;
- Any amount of the repayment of shareholder loans is not taxable to the shareholder; and
- The gain or loss on disposition of the S corporation shares has been properly computed, which includes the disposition of the shares in a year the S corporation is liquidated.

When the New Client Hasn't Tracked Basis

If the taxpayer begins tracking basis with the first return the S corporation investment appears on, Form 7203 presents no real challenge in most cases. The *Tax Notes Today Federal* article quoted Nathan Smith of CBIZ Inc. on how difficult the Form 7203 processing was:

> "We saw a few questions come up from time to time, but by and large it was pretty much smooth sailing," said Nathan Smith of CBIZ Inc. "Unlike the Schedule K-2 and K-3 disaster, the new standardized reporting on Form 7203 was fairly seamless."[29]

But the article notes that things become a lot more difficult if the professional takes on a new client who has not been tracking the information:

> While the form wasn't a struggle for those who were already tracking basis, it highlighted the problem that tax professionals face when taking on new clients who weren't tracking it themselves and whose preparers weren't doing it either.[30]

A client who comes to the practitioner with no prior records related to basis has always required the practitioner to deal with obtaining information to determine what is

[29] Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," *Tax Notes Today Federal,* June 1, 2022

[30] Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," *Tax Notes Today Federal,* June 1, 2022

beginning basis and if the taxpayer may have reported losses in the past or avoided reporting gain on distributions that means prior returns contain errors.

There are various ways a professional may obtain basis information. For now, we'll consider three options that the practitioner should consider.

Recalculate Basis from Day One

Clearly the best option to deal with obtaining basis information for a taxpayer who has not tracked basis in the past is to obtain the information for each prior year to properly compute stock and debt basis. The Form 7203 itself serves as an excellent set of worksheets to prepare for each year to obtain a comprehensive and easily defendable calculation of basis up through the beginning of the year the practitioner is first looking to prepare.

One key fact to keep in mind is the absolute rule that basis can *never* go below zero. Generally, if events occur that would push basis below zero, the "excess" reduction is taken care of either by limiting deductions to the amount that takes basis to zero (and carrying such disallowed losses to the next taxable year) or by recognizing a gain on distributions.

Later we'll discuss options to deal with this situation in closed years based on IRS documents. While these documents are not binding authority, they contain analyses that do cite to binding authority and aren't likely to be challenged by IRS examiners if the taxpayer conforms to the methods described.

But, for now, when computing basis we simply note that such "problematical" events occurred in a year but still treat ending basis as zero.

While this option is by far the best, in many cases it is not possible to obtain all data necessary to do the full calculation using the schedules for each year. We'll discuss some options to deal with this situation, realizing that it's very possible the IRS will challenge any such calculation on exam—and may very well succeed in pushing down the basis.

Even if it is possible to obtain the data, clients may balk at the effort and cost involved in obtaining the data. The adviser should strongly suggest the client take the steps necessary to obtain the information and have fully supported basis calculations should the IRS examine his/her return. Remember that the problem exists because the taxpayer failed to take the steps *required* of the taxpayer to prepare the prior year's returns.

While that may have been due to inadequate work done by a paid preparer, it's not due to inadequate work done by the preparer taking on the return—but if the preparer simply acquiesces in the client's whining about not wanting to have the work done to properly calculate basis, the preparer may find that he/she now will be deemed by the client to have "blessed" the less desirable method—and the client may look for compensation should the IRS successfully challenge the return later.

IRS LB&I Process Unit Methods

The *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*[31] describes a number of issues IRS examiners may encounter in examining S corporations and their shareholders. The recommendations for steps for examining agents to take when faced with imperfect information on basis are found in this document.

In the section entitled "Losses Claimed in Excess of Basis" the document suggests the following steps be taken when historical information is not available:

> When historical records are not available to substantiate the shareholder's initial stock basis or the adjustments to basis since making the S election, estimate initial stock basis by taking the earliest S corporation return available and adding:
>
> - beginning capital stock,
> - beginning additional paid-in capital,
> - beginning accumulated adjustments account, and
> - beginning other adjustments account.
>
> Multiply the total by the shareholder's ownership percentage to arrive at each individual's estimated initial stock basis[32]

[31] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018, https://www.irs.gov/pub/irs-utl/sco_p_53_05_01_03_06.pdf (retrieved June 5, 2022)

[32] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

The document provides two examples of performing such a calculation:

Example 1 – Estimating Initial Stock Basis Using the Return Resulting in Positive Basis

The balance sheet and Schedule M-1 show the following information:

*Accumulated Adjustments Account (AAA)

**Other Adjustments Account (OAA)

	Beginning	Ending
Capital Stock (Line 22)	45,000	60,000
Additional Paid in Capital (Line 23)	0	0
Retained Earnings (Line 24)	(22,000)	(86,000)

	AAA*	OAA**
1. Balance at beginning of the Year	(21,000)	1,000
2. Ordinary Income from page 1, line 21	0	
3. Other additions	0	0
4. Loss from page 1, line 21	(64,000)	
5. Other reductions	0	0
6. Combined lines 1 through 5	(85,000)	1,000
7. Distributions other than dividends	0	0
8. Balance at end of year	(85,000)	1,000

Based on this information, the estimated beginning stock basis is computed as follows:

Beginning Capital Stock	45,000
Plus: Beginning Additional Paid in Capital	0
Equals: Beginning Stock Cost	45,000
Plus: Beginning AAA and OAA	(20,000)
Equals: Estimated Beginning Stock Basis	25,000

If there is more than one shareholder, multiply the $25,000 by each shareholder's ownership percentage to determine each shareholder's estimated initial stock basis. For example, if there are two equal shareholders, then take the estimated beginning stock basis of $25,000 times 50-percent ownership, which equals $12,500 of estimated beginning stock basis for each shareholder.[33]

[33] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

Example 2 – Estimating Initial Stock Basis Using the Return Results in Negative Basis[34]

The corporation made its S election in 2000, but the earliest S corporation return available is 2012. Therefore, the 2012 return is used to estimate initial stock basis. The balance sheet and Schedule M-1 show the following information:

	Beginning
Capital Stock (Line 22)	45,000
Additional Paid in Capital (Line 23)	0
Retained Earnings (Line 24)	(22,000)

	AAA	OAA
1. Balance at beginning of the Year	(98,000)	0
2. Ordinary Income from page 1, line 21	0	
3. Other additions	0	
4. Loss from page 1, line 21	(64,000)	
5. Other reductions	0	
6. Combined lines 1 through 5	(162,000)	0
7. Distributions other than dividends	0	
8. Balance at end of year	(162,000)	0

Based on this information, the estimated beginning stock basis is computed as follows:

Beginning Capital Stock	45,000
Plus: Beginning Additional Paid in Capital	0
Equals: Beginning Stock Cost	45,000
Plus: Beginning AAA and OAA	(98,000)
Equals: Estimated Beginning Stock Basis	(53,000)

However, IRC 1367(a)(2) states that basis cannot be decreased below zero. A negative estimated initial stock basis indicates the S corporation generated losses or paid distributions greater than the income it earned in years prior to 2012. Assuming the shareholder's 2012 return and basis computation do not report $53,000 in suspended losses, a suspense account must be established to track the ($53,000). TAM 200619021, FSA 200230030 and TAM 9304004.

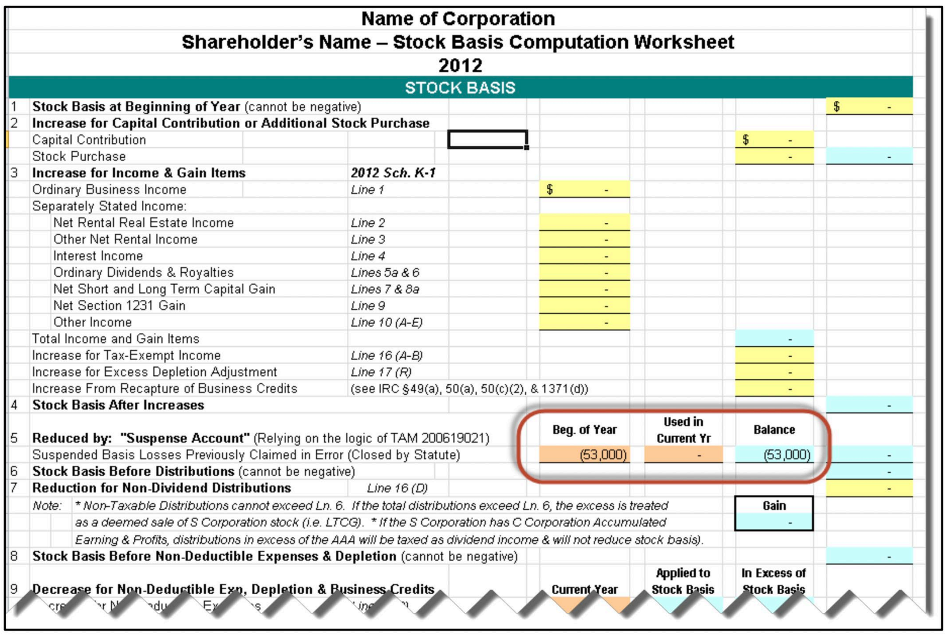
This example assumes debt basis is zero. If there is debt basis of at least $53,000, then the beginning debt basis amount would be reduced by the $53,000 loss instead of establishing a suspense account. Also, if the shareholder has a NOL carryforward of at least $53,000 from an open statute year, then the NOL is decreased instead establishing a suspense account.

[34] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

As in Example 1, if there is more than one shareholder, multiply the ($53,000) by the shareholder's ownership percentage to determine each shareholder's suspense account.

The suspense account is entered on the Stock Basis Worksheet and the Stock & Debt Basis Workbook as follows:

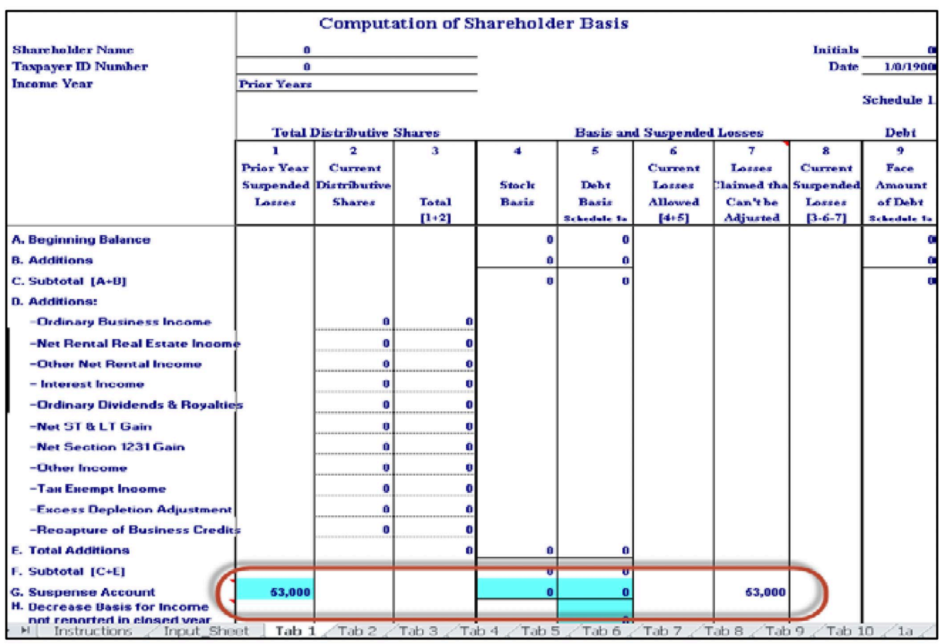
For more information on the suspense account see the Audit Tool – S Corporation Shareholder Loss Limitations Issue Guide.



Name of Corporation
Shareholder's Name – Stock Basis Computation Worksheet
2012

STOCK BASIS

1	**Stock Basis at Beginning of Year** (cannot be negative)					$ -
2	**Increase for Capital Contribution or Additional Stock Purchase**					
	Capital Contribution				$ -	
	Stock Purchase				-	-
3	**Increase for Income & Gain Items**	*2012 Sch. K-1*				
	Ordinary Business Income	*Line 1*	$ -			
	Separately Stated Income:					
	Net Rental Real Estate Income	*Line 2*	-			
	Other Net Rental Income	*Line 3*	-			
	Interest Income	*Line 4*	-			
	Ordinary Dividends & Royalties	*Lines 5a & 6*	-			
	Net Short and Long Term Capital Gain	*Lines 7 & 8a*	-			
	Net Section 1231 Gain	*Line 9*	-			
	Other Income	*Line 10 (A-E)*	-			
	Total Income and Gain Items				-	
	Increase for Tax-Exempt Income	*Line 16 (A-B)*			-	
	Increase for Excess Depletion Adjustment	*Line 17 (R)*			-	
	Increase From Recapture of Business Credits	(see IRC §49(a), 50(a), 50(c)(2), & 1371(d))			-	
4	**Stock Basis After Increases**					-
			Beg. of Year	**Used in Current Yr**	**Balance**	
5	**Reduced by: "Suspense Account"** (Relying on the logic of TAM 200619021)					
	Suspended Basis Losses Previously Claimed in Error (Closed by Statute)		(53,000)	-	(53,000)	-
6	**Stock Basis Before Distributions** (cannot be negative)					-
7	**Reduction for Non-Dividend Distributions**	*Line 16 (D)*				-
	*Note: * Non-Taxable Distributions cannot exceed Ln. 6. If the total distributions exceed Ln. 6, the excess is treated as a deemed sale of S Corporation stock (i.e. LTCG). * If the S Corporation has C Corporation Accumulated Earning & Profits, distributions in excess of the AAA will be taxed as dividend income & will not reduce stock basis).*				**Gain** -	
8	**Stock Basis Before Non-Deductible Expenses & Depletion** (cannot be negative)					-
			Current Year	**Applied to Stock Basis**	**In Excess of Stock Basis**	
9	**Decrease for Non-Deductible Exp, Depletion & Business Credits**					



Computation of Shareholder Basis

Shareholder Name: 0 — Initials: 0
Taxpayer ID Number: 0 — Date: 1/0/1900
Income Year: Prior Years

Schedule 1

	Total Distributive Shares			Basis and Suspended Losses					Debt
	1 Prior Year Suspended Losses	2 Current Distributive Shares	3 Total [1+2]	4 Stock Basis	5 Debt Basis Schedule 1a	6 Current Losses Allowed [4+5]	7 Losses Claimed tha Can't be Adjusted	8 Current Suspended Losses [3-6-7]	9 Face Amount of Debt Schedule 1a
A. Beginning Balance				0	0				0
B. Additions				0	0				0
C. Subtotal [A+B]				0	0				0
D. Additions:									
-Ordinary Business Income		0	0						
-Net Rental Real Estate Income		0	0						
-Other Net Rental Income		0	0						
- Interest Income		0	0						
-Ordinary Dividends & Royalties		0	0						
-Net ST & LT Gain		0	0						
-Net Section 1231 Gain		0	0						
-Other Income		0	0						
-Tax Exempt Income		0	0						
-Excess Depletion Adjustment		0	0						
-Recapture of Business Credits		0	0						
E. Total Additions			0	0	0				
F. Subtotal [C+E]				0	0				
G. Suspense Account	53,000			0	0		63,000		
H. Decrease Basis for Income not reported in closed year									

Instructions | Input_Sheet | Tab 1 | Tab 2 | Tab 3 | Tab 4 | Tab 5 | Tab 6 | Tab 7 | Tab 8 | Tab 9 | Tab 10 | 1a

The document also notes that it's important to understand how the S corporation shareholder acquired his/her shares when using these estimation methods:

> Note: It is important to establish how and when each shareholder acquired basis in the S corporation as the above estimate may need to be modified as a result of ownership changes. If the estimate appears to be unreasonable based on the facts and circumstances, then consider using zero as the initial stock basis.[35]

Other Methods – *Cohan* Case

The basic authority for the estimation methods the IRS discussed comes from the case of *Cohan v. Commissioner*.[36] That case established that if the evidence makes it clear that the taxpayer should qualify for some deduction but does not have sufficient records to document the amount, the taxpayer will still be allowed some deduction to the extent the amount he/she should be allowed can reasonably be estimated, taking into account the taxpayer's level of responsibility for a lack of adequate records.

While the IRS clearly is relying on this case to justify the proposed methods, an adviser might find some other reasonable methodology to compute basis and then be ready to defend that method if necessary.

Losses Previously Claimed in Excess of Basis

The IRS document goes on to advise examining agents regarding what to do when they discover losses in excess of basis have been claimed in prior years. Advisers may discover the same issue when looking to determine basis for new clients.

Step 2 of the process of dealing with losses claimed in excess of basis discussed first the absolute rule, noted earlier, that basis can never drop below zero, so basis becomes zero for the year following the year when excess losses are claimed:

> Stock basis can never be reduced below zero. Therefore, even if a loss is claimed in excess of basis, the stock basis at the beginning of the following year is zero.[37]

If these losses were claimed in years closed to IRS assessments by statute, you might think this reset to zero means the taxpayer "wins" in this case, but the document goes

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[35] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[36] *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930)

[37] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

on to provide a methodology that could very well allow the IRS to recover that excess tax benefit by using a suspense account:

> National Office's position is that if a shareholder claims losses in excess of basis in a year closed by statute, then the shareholder must suspend all future tax-free distributions and losses from the S corporation until the excess losses claimed, but not allowed, are recaptured. FSA 200230030; TAM 200619021 and PLR 9304004.[38]

As is noted, the IRS has brought this concept up in documents dating back to 1993.

The guide also provides the agent with citations to use against an attempt by the taxpayer to argue the agent has no right to look at "closed" years:

> IRC 7602(a)(1) authorizes the examiner to examine any books, papers, records, or other data which may be relevant or material to determine the correctness of any return, including information from prior years not under examination or closed by statute. IRC 6214(b) allows the Tax Court to determine the correct tax liability for the open year(s) by referring, as necessary, to facts from other years. *Lone Manor Farms, Inc. v. Commissioner* - 61 T.C. 436, 440-441 (1974); *Goldsmith v. Commissioner* - T.C. Memo. 2017-20.[39]

The document outlines how the suspense account is absorbed in open years:

> If a taxpayer claims a loss in excess of basis in a closed statue year, then a suspense account is created, pursuant to IRC 1366(d)(2), to track the excess losses. The balance in the suspense account must be reduced to zero before the taxpayer is allowed to take tax-free non-dividend distributions or report pass-through losses. TAM 200619021 explains that the "suspended basis losses claimed in error" should reduce stock basis before current year distributions, non-deductibles and losses and deductions are taken into account.[40]

The steps the LB&I document outlines for agents to take are:

- Review the basis computation schedule and identify any years for which the losses and deductions exceed the shareholder's basis.

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[38] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[39] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[40] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

- Compare the basis computation to the shareholder's return to determine if the losses claimed in closed statute years exceed basis.

- Establish or increase the suspense account for any losses and deductions claimed in excess of basis in closed statute years.[41]

The document provides the following example of applying these procedures:

Example 3 – Suspense Account[42]

Mary, the sole owner of an S corporation, reported the following income and deduction items on Form 1040 for 2013 (a closed statute year), as reported on Schedule K-1:

Ordinary Income	5,000
Section 1231 Loss	(8,000)
Charitable Contributions	(1,000)

The shareholder's beginning stock and debt basis was zero. As 2013 is a closed statute year, the suspense account is computed as follows:

Beginning Basis	0
Ordinary Income	5,000
Section 1231 Loss	(8,000)
Charitable Contributions	(1,000)
Suspense Account	(4,000)

[41] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[42] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

The suspense account is entered on the Stock Basis Worksheet and the Stock & Debt Basis Workbook as follows:

For more information on the suspense account see the Audit Tool – S Corporation Shareholder Loss Limitations Issue Guide.

S Corporation
Mary – Stock Basis Computation Worksheet
2013

STOCK BASIS

1 **Stock Basis at Beginning of Year** (cannot be negative)							$ -
2 **Increase for Capital Contribution or Additional Stock Purchase**							
Capital Contribution						$ -	
Stock Purchase						-	-
3 **Increase for Income & Gain Items**	***2012 Sch. K-1***						
Ordinary Business Income	*Line 1*			$ 5,000			
Separately Stated Income:							
Net Rental Real Estate Income	*Line 2*			-			
Other Net Rental Income	*Line 3*						
Decrease for Depletion	*Line 17 (R)*						
Decrease for Business Credits (see IRC §50(c)(1) & (5))				-	-	-	-
Note: If the above exceed stock basis, the excess is applied to the S/H's debt basis. The amount in excess of debt basis is not carried over.							
10 **Stock Basis Before Allowable Losses & Deductions** (cannot be negative)							5,000

11 **Decrease for Loss & Deduction Items**	***2012 Sch. K-1***	Current Year Distributive Share	Carryover Amount #	Allowable Loss & Deductions	Losses Claimed That Can't be Adjusted @	Suspended Basis C/O	
Ordinary Business Loss	*Line 1*	-	-	-	-	-	
Separately Stated Loss & Deductions:							
Net Rental Real Estate Loss	*Line 2*		-	-	-	-	
Other Net Rental Loss	*Line 3*	-	-	-	-	-	
Net ST & LT Capital Loss	*Lines 7 & 8a*	-	-	-	-	-	
Net Section 1231 Loss	*Line 9*	(8,000)	-	(4,444)	(3,556)	0	
Other Loss	*Line 10 (A-E)*	-	-	-	-	-	
Section 179 Deduction	*Line 11*	-	-	-	-	-	
Charitable Contributions	*Line 12 (A-G)*	(1,000)	-	(556)	(444)	(0)	
Investment Interest Expense	*Line 12 (H)*	-	-	-	-	-	
Deductions - Royalty Income	*Line 12 (I)*	-	-	-	-	-	
Section 59(e)(2) Expenditures	*Line 12 (J)*	-	-	-	-	-	
Portfolio Income Expenses	*Line 12 (K-L)*	-	-	-	-	-	
Other Deductions	*Line 12 (M-O & S)*	-	-	-	-	-	
Foreign Taxes Paid/Accrued	*Line 14 (L-M)*	-	-	-	-	-	
					(4,000)	(0)	
Total Allocated Loss & Deductions	(9,000)						
Total Allowable Loss & Deductions							(5,000)
12 **Stock Basis at End of Year** (cannot be negative)							$ -

	Total Distributive Shares			Basis and Suspended Losses					Debt
	1 Prior Year Suspended Losses	2 Current Distributive Shares	3 Total [1+2]	4 Stock Basis	5 Debt Basis Schedule 2a	6 Current Losses Allowed [4+5]	7 Losses Claimed that Can't be Adjusted	8 Current Suspended Losses [3-6-7]	9 Face Amount of Debt Schedule 2a
A. Beginning Balance				0	0				0
B. Additions				0	0				0
C. Subtotal [A+B]				0	0				0
D. Additions:									
-Ordinary Business Income		5,000	5,000						
-Net Rental Real Estate Income		0	0						
-Other Net Rental Income	0	0					0		
-Net ST & LT Capital Loss	0	0	0	0	0		0	0	
-Net Section 1231 Loss	0	8,000	8,000	4,444	0	4,44	3,556	0	
-Other Loss	0	0	0	0	0		0	0	
-Section 179 Deduction	0	0	0	0	0		0	0	
-Charitable Contributions	0	1,000	1,000	556	0	55	444	0	
-Investment Interest Expense	0	0	0	0	0		0	0	
-Deductions - Royalty Income	0	0	0	0	0		0	0	
-Section 59(e)(2) Expenditures	0	0	0	0	0		0	0	
-Portfolio Income Expense	0	0	0	0	0		0	0	
-Other Deductions	0	0	0	0	0		0	0	
-Foreign Taxes Paid/Accrued	0	0	0	0	0		0	0	
O. Total Subtractions			9,000	5,000	0		4,000		
P. Subtotal [M-O]				0	0				
Q. Net Increase (Decrease) [E-J-L-O]			-4,000						
R. Other Stock Reductions and Debt Repayments				0	0				0
S. Ending Balance (Not Below Zero)				0	0				0

The IRS document discusses the general rules for handling losses in excess of basis

> The amount of losses and deductions taken by a shareholder for any taxable year cannot exceed the sum of the shareholder's stock basis and the adjusted basis of any S corporation indebtedness owed to the shareholder (debt basis).
>
> When stock and debt basis is insufficient, and there is more than one type of loss or deduction item that reduces basis, the amounts allowed as losses or deductions are allocated on a pro rata basis. The pro rata allocation is computed dividing the loss or deduction item by the total loss and deduction items and multiplying the resulting percentage by the available basis.
>
> Any losses or deductions disallowed for any taxable year are suspended and carried forward indefinitely until the shareholder has adequate stock or debt basis. The suspended losses retain their character and are carried forward and treated as incurred in the first succeeding year.

> If the stock is sold or otherwise disposed of, then the suspended losses are no longer carried forward and are lost forever.[43]

The IRS outlines the following steps to absorb suspense accounts:

- If the shareholder has a suspense account, then reduce the shareholder's basis by the lesser of
  - the absolute value of the suspense account, or
  - the basis after the current-year increases.
- Review the basis computation schedule and identify open statute years for which the losses and deductions exceed the shareholder's basis.
- Compare the basis computation to the shareholder's return to determine if the losses claimed in open statute years exceed basis.
- Disallow any losses or deductions in excess of basis, verifying that each loss or deduction item is properly limited on a pro-rata basis.[44]

The IRS provides two examples of applying the rules:

Example 4 – Allocation of Losses and Deductions[45]

The sole owner of an S corporation has stock basis of $9,000 at the beginning of the year. During the year, the S corporation generated the following:

Ordinary Loss	(20,000)
Section 1231 Gain	4,000
Cash Charitable Contributions	5,000
Non-Deductible Travel & Entertainment	1,000

Since the items that reduce basis exceed the shareholder's stock basis, the loss is limited to the amount of stock basis. First, the stock basis ordering rules are applied to arrive at stock basis before losses and deductions. Since there is more than one type of loss and

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[45] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

deduction item which reduces basis, the amounts allowed as a loss or deduction must be prorated as follows:

Beginning Stock Basis	9,000	
IRC 1231 Gain	4,000	
Stock Basis Before Non-Deductible Exp.	13,000	
Non-Deductible Travel & Entertainment	(1,000)	
Stock Basis Before Losses & Deductions	12,000	
Ordinary Loss	(9,600)	((20,000 / (20,000 + 5,000)) x 12,000
Cash Charitable Contribution	(2,400)	((5,000 / (20,000 + 5,000)) x 12,000
Ending Stock Basis	0	

The carry over to the next taxable year is:

Ordinary Loss	(10,400)	(20,000) – (9,600)
Cash Charitable Contribution	(2,600)	(5,000) – (2,400)
Total Carryover	(13,000)	(25,000) – (12,000)

Note: Even though this example uses a 100% shareholder, the allocation applies to all shareholders. If a shareholder owns 25% of the S corporation stock, the ordinary income and separately stated items are first allocated 25% to that shareholder. That shareholder then looks to his basis to see if the allocated amount is fully deductible.

Example 5 – Treatment of Suspended Loss Items[46]

Continued from Example 4, during Year 2, the S corporation generated the following:

Ordinary Income	35,000
Section 1231 Loss	(10,000)
Cash Charitable Contributions	1,000
Non-Deductible Travel & Entertainment	5,000

The shareholder's stock basis at the beginning of the year is $0. Losses suspended in a previous year are treated as being incurred in the next tax year and can only be deducted when basis is increased.

Beginning Stock Basis Year 2	0
Ordinary Income	35,000
Stock Basis Before Non-Deductible Exp.	35,000
Non-Deductible Travel & Entertainment	(5,000)
Stock Basis Before Losses & Deductions	30,000

Ordinary Loss	(10,400)	(0 + (10,400))
IRC 1231 Loss	(10,000)	
Cash Charitable Contribution	(3,600)	((1,000) + (2,600))
Ending Stock Basis Year 2	6,000	

Although the Schedule K-1 only shows the current year income items, the shareholder is allowed to take the previously suspended losses. Suspended losses may not be combined with current income amounts, but must be listed on a separate line on the

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Form 1040, Schedule E, Supplemental Income and Loss, or the appropriate schedule when possible. Suspended ordinary loss carryover is not netted with the current year ordinary income when applying the stock basis ordering rules. Treas. Reg. 1.1366-2(a)(3) & (4).