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Can You Deduct Your S Corporation Losses?

Stock Basis and At-Risk Limitations

You can deduct S Corp losses if they pass certain tests.

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WHAT IS AN S CORPORATION?
S Corporations are “flow-through” tax entities, meaning income, deductions, credits and other activity are allocated to shareholders to be reported on their individual tax returns. When shareholders are allocated losses from an S Corporation they can use the losses to offset income from other sources — if the losses pass three tests, the first two of which, “stock basis” and “at-risk” limitation rules, are the subject of this article. Both are based on how the loss was funded.

The goal of stock basis and at-risk limitation rules is to limit a shareholder’s use of losses to those that have been personally funded by the shareholder. S Corporation shareholders can take losses to the extent of their personal investment in the corporation. Losses funded by loans from unrelated parties or loans from the shareholders of funds that are not at risk cannot be deducted. Instead, the losses are suspended and carried forward until the shareholder increases their stock basis and amount at risk.

TEST NO. 1: STOCK BASIS
A shareholder’s initial stock basis is determined by how they acquire their interest in the S Corporation: the money and other property a shareholder contributes to start the corporation or the amount paid to purchase shares in the corporation. If S Corporation shares are gifted, the recipient is also gifted the donor’s basis in the shares. The basis of inherited shares is adjusted to the fair market value at time of the decedent’s death.

From the initial basis, a shareholder’s basis can be increased by capital contributions, personal loans to the corporation, and income allocated to the shareholder; or decreased by distributions, repayment of loans from the shareholder, and losses allocated to the shareholder. If a shareholder has stock basis in excess of their loss at the end of the tax year, they pass the first test in determining whether or not they can deduct the loss.

TEST NO. 2: AT-RISK LIMITATION
To deduct an S Corporation loss, the taxpayer must also be sufficiently at risk. Simply stated, a shareholder’s amount at risk is the extent to which they have dipped into their
A shareholder is only at risk for loans it makes to the corporation if the shareholder is at risk for the funds loaned to the corporation.

While an S Corporation shareholder receives stock basis for loans made to the corporation they are not always at risk for the debt. A shareholder is only at risk for loans it makes to the corporation if the shareholder is at risk for the funds loaned to the corporation. We often encounter scenarios where a shareholder personally borrows money and loans the proceeds to the S Corporation, a so-called “back-to-back” loan. A shareholder is not at risk for a back-to-back loan unless they are personally liable for the repayment of the loan, or if they have pledged property other than S Corporation property or their S Corporation stock as security for the loan. If the loan to the shareholder is “non-recourse,” meaning they are not personally liable for the repayment, they will not receive at-risk basis by loaning the proceeds to their S Corporation.

If you are a shareholder in an S Corporation that has incurred a loss during the tax year, and you pass the stock basis and at-risk tests, you’re two-thirds of the way home in terms of being able to deduct your losses.