



American Institute of CPAs
1455 Pennsylvania Avenue, NW
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February 21, 2017

The Honorable John A. Koskinen
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Internal Revenue Service
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Washington, DC 20224

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Acting Chief Counsel
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Mr. Thomas C. West
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Department of the Treasury
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Mr. John P. Moriarty
Acting Associate Chief Counsel
Passthroughs and Special Industries
Internal Revenue Service
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Re: Recommendation to Develop a New Income Tax Form to Improve S Corporation
Shareholder Compliance with the Basis Rules of Section 1367

Dear Messrs. Koskinen, Paul, West, and Moriarty:

The American Institute of CPAs (AICPA) appreciates the opportunity to submit the following recommendation to improve S corporation shareholder compliance with the basis rules under subchapter S. The AICPA recommends the Internal Revenue Service (IRS) develop a required form for shareholders to attach to any income tax return which includes items of income, loss, deduction, or credit of an S corporation. This form would compute a shareholder's basis in the stock and debt of the S corporation.

Our comments below were developed by the AICPA S Corporation Taxation Technical Resource Panel and approved by the Tax Executive Committee.

BACKGROUND

Noncompliance with the S corporation basis rules has been the subject of numerous discussions and studies. Without accurate tracking of shareholder stock and debt basis, a taxpayer may not know whether he or she is entitled to deduct losses flowing from the S corporation or whether distributions and/or loan repayments from the S corporation to the shareholder are taxable or nontaxable. These issues may result in taxpayers improperly claiming losses and deductions in excess of basis, failing to report as taxable gain distributions or loan repayments in excess of basis, and/or reporting inaccurate gains or losses on dispositions of S corporation stock. Tax preparers often face a dilemma when accepting new clients from previous tax return preparers who have not performed or properly documented the computation of a shareholder's basis in an

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S corporation. Some clients are not even able to provide properly maintained records that are necessary for a tax return preparer to accurately compute the basis.

A December 2009 GAO Report on the tax gap¹ expands on this issue and indicates that stakeholder representatives claimed that “calculating and tracking basis was one of the biggest challenges in complying with S corporation rules.” The report analyzed audit examinations for fiscal years 2006 through 2008 and found over \$10 million of misreported losses for taxpayers who were improperly benefitting by deducting losses to which they were not entitled, due to lack of basis.

We believe that a significant contributing factor to S corporation shareholders claiming losses in excess of basis is that S corporation shareholders are not required to attach a form, to his or her income tax return, on which their basis in the S corporation is computed and the loss limitation rules are applied.

Recommendation to Not Require S Corporations to Maintain Shareholder Basis at the Entity Level

The AICPA recommends the IRS develop a new shareholder-level income tax form that is required for shareholders to attach to any income tax return with items of income, loss, deduction, or credit of an S corporation. This form would compute a shareholder’s basis in the stock and debt of the S corporation.

The December 2009 GAO Report, referenced above, developed options for improving compliance with S corporation rules and included three recommendations relating to the calculation of basis as follows:

- a. Legislative change to require basis calculation at the entity level;
- b. IRS mailing information on basis calculation to new S corporations; or
- c. IRS issuing clear, concise guidance for calculating debt basis.

Although implementing the above suggestions may improve compliance with the S corporation rules, we do not support the first item included in the GAO report which recommends a legislative change that requires the S corporation to calculate and maintain shareholder basis. While an S corporation has the information necessary to determine a shareholder’s annual adjustments to basis under subchapter S, it generally would not have other information necessary to make a proper determination of shareholder basis. Examples of basis computation concerns include:

¹ Government Accountability Office, “[TAX GAP - Actions Needed to Address Noncompliance with S Corporation Tax Rules](#),” GAO-10-195, December 2009.

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- a. An S corporation would not typically have a shareholder's initial basis in his or her stock, which is critical information required to properly compute basis;
- b. A shareholder may have multiple lots of S corporation stock purchased or acquired on different dates and at different prices. If this shareholder makes a partial disposition of S corporation stock, the S corporation would not necessarily have the information needed to identify the specific lot from which the disposition occurred and, correspondingly, the proper adjustment to basis;
- c. There are other items that can affect a shareholder's basis of which the S corporation is unaware (e.g., the increase in basis for gift tax paid under section 1015(d));² and
- d. The election under Treas. Reg. § 1.1367-1(g) relating to the elective ordering rule may affect a shareholder's basis calculation. This particular election, however, is made at the shareholder level, not the S corporation level.

While we recognize that any legislation can require a shareholder to provide the S corporation with the information necessary for the S corporation to compute the shareholder's basis, it is inefficient to have the shareholder provide this information to the entity, only to require that the entity provide the same information back to its shareholder. Furthermore, requiring an S corporation to provide shareholder basis would place an undue burden on these entities that may have a significant number of shareholders.

Through Schedule K-1 reporting, S corporations are already required to provide their shareholders with the information necessary to properly adjust basis for items arising at the corporate level. By providing these details, a shareholder, in contrast to the S corporation, should have all of the information needed to properly compute basis in the entity.

Finally, we note that merely providing a shareholder with his or her basis in the S corporation does not mean that the shareholder can properly utilize this information in applying loss and deduction limitations and/or in determining the taxability of distributions or loan repayments from the S corporation.

In regards to the second and third GAO report recommendations listed above, we believe that the implementation of these particular items may improve compliance with the S corporation rules, but are likely inadequate to produce a meaningful or effective result.

Recommendation to Develop an Income Tax Form on Which Basis is Reported

An S corporation shareholder is responsible for properly determining federal income tax liability, taking into account S corporation items and applying the S corporation rules. However,

² All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.

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taxpayers need assistance to comply with basis computations because failure to properly apply the basis limitations is a common area of unintentional noncompliance with S corporation rules.

As mentioned above, an S corporation provides to its shareholders, on Schedules K-1, all of the information available at the corporate level necessary for its shareholders to properly determine adjustments to basis for the taxable year. Currently, however, there is no form that shareholders must file with their income tax return that computes the basis while also applying an S corporation's basis rules relating to loss limitations and the taxability of distributions, loan repayments, and stock dispositions. We believe that shareholder compliance with S corporation basis rules can significantly improve with the development of this type of basis computation form, together with the requirement that the form is attached to any income tax return with items of income, loss, deduction, or credit of an S corporation.

Tax preparation software will also need updates to include this new required form. While developing the new form, software programs can incorporate the ability to apply S corporation basis rules to calculations. A new basis reporting form can also provide tax return preparers with the support necessary to obtain information from S corporation shareholders and maintain shareholder basis even when the S corporation basis rules do not come into effect for determining a shareholder's liability for tax (e.g., when the S corporation is profitable and not making distributions or loan repayments).

This new computation form can also significantly improve the efficiency and accurateness of IRS audits of shareholders' compliance with the S corporation basis rules.

RECOMMENDATIONS

The AICPA recommends that the IRS develop a new shareholder-level income tax form that shareholders are required to attach to any income tax return with items of income, loss, deduction, or credit of an S corporation. The purpose of the form is to compute the S corporation shareholder's basis in the stock and debt of the S corporation. The form can provide both shareholders and the IRS with the information necessary to properly determine the taxability of distributions and loan repayments made by the S corporation to its shareholders, gain or loss on stock dispositions, as well as the amount of losses and deductions that shareholders are allowed to take into account when computing taxable income for the year. We believe that the development of this form can benefit all relevant stakeholders (i.e., taxpayers, the IRS, and tax return preparers). We are available to assist in the development or review of this proposed shareholder basis form.

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since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. Please feel free to contact me at (408) 924-3508 or Annette.Nellen@sjsu.edu; Laura Macdonough, Chair, AICPA S Corporation Taxation Technical Resource Panel, at (202) 327-8060 or laura.macdonough@ey.com; or Amy Wang, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9264 or amy.wang@aicpa-cima.com.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Annette Nellen". The signature is fluid and cursive, with the first name being more prominent.

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee