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Suspended Losses Offer Potential Tax Benefits

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Many businesses today are struggling to maintain viability.

S-corporation businesses and their shareholders need to be aware that certain tax attributes, such as losses, retain value and there may be an opportunity for using losses.

S-corporations are pass-through entities which, instead of reporting their own income and losses, pass them through to the shareholders, who report the items on their own returns. Pass-through treatment requires the S-corporation to allocate its income and losses to shareholders instead of incurring its own tax liability; the shareholders report income and loss items on their personal tax returns. (There are limited circumstances in which this rule does not apply.)

"Basis" — which reflects a shareholder's equity — limits a shareholder's ability to apply his allocation of losses against income. For example, if a shareholder made an initial investment of $100, he has a $100 basis and $100 of equity in the corporation. A $10 allocation of income provides a $110 basis and a $3 loss allocation will make a total of $107 basis.

A loss allocation will reduce a shareholder's basis, but a shareholder may not take any loss deductions in excess of basis. If the corporation allocates an excessive loss, the loss will be suspended until the shareholder regains basis by either making a contribution to the corporation's capital or receiving a new allocation of income.

For example, suppose a shareholder has a basis of $500 in an S-corporation. As the corporation begins to fail, the shareholder receives an annual allocation of $300 of loss — and no income — for two consecutive years.

In the first year, his loss deduction reduces his basis to $200. In the second year, his $200 basis limits him to $200 of losses. The excess $100 belongs to the shareholder as a suspended loss, which the shareholder may carry forward until he is able to use it.

Merger or acquisition-type reorganizations involving more profitable S-corporations become appealing as S-corporations try to survive, but these transactions can affect the shareholders' ability to take suspended losses.

Suppose that the terms of a reorganization result in the shareholders of the failing S-corporation owning a much smaller ownership interest in the new S-corporation than previously held.

Instead of each owner holding a 50 percent interest, they each hold a 5 percent interest. This flip from big fish to little fish could occur because the failing corporation is worth only $100 at the time of the reorganization and it is purchased by a corporation worth $2,000.

What happens to the shareholders' suspended losses?

The losses were allocated in the failing corporation based on a 50 percent interest, but can they be applied against 5 percent income allocations? Must the losses be reduced? Does this shareholder flip prevent the shareholders from taking any suspended losses at all?

No. The flip in ownership interest will not cause any shareholder to lose losses, nor will it prevent him from applying those losses against 5 percent (or any percent) of income from a new S-corporation, as long as two criteria are met.

First, the shareholder must remain a shareholder in the new S-corporation after the reorganization, even if holding only a small interest.

Second, the new corporation must be considered a "successor" under federal tax law. If, instead, a shareholder decides he will not remain an owner but will sell his interest prior to the reorganization, more complicated rules will apply to the gain or loss on that sale and to his use of any losses.

The good news is that the shareholders who remain will have suspended losses for the future. However, a smaller interest in the new corporation post-reorganization may result in a longer period of time for those losses to be absorbed.

For example, suppose the failing corporation shareholders in our example each have $500 in suspended losses. In the year after the reorganization, the new corporation has $2,000 of income to allocate (which is a consistent amount of annual income).

Had this influx of income occurred before the transaction, each shareholder would have been allocated $1,000, and the suspended losses would be absorbed. However, post-reorganization, there will only be a $100 allocation to each. Where previously, suspended losses would have been absorbed in one year, the subsequent 5 percent interest causes absorption to take longer.

This example demonstrates that even without forfeiture, the relationship between the shareholders and their suspended losses will change, and the actual impact of the change will depend greatly on the facts surrounding the particular reorganization.

The above discussion may be a catalyst for S-corporation owners facing losing the time and energy put into a venture as well as the suspended losses it generated.

However, lost losses are not something to fear in a merger or acquisition even when the losses seem immense.

Of course, it is important that shareholders who wish to preserve suspended losses make certain that they have actual ownership for tax purposes and that they own a new S-corporation that qualifies as a successor under the law.

In any reorganization transaction, S-corporations and their shareholders are encouraged to consult a tax lawyer who can provide such assurances.

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