Natalie C. Papagni, CPA

TAX, PLANNING & ADVISORY SERVICES • LA JOLLA, CALIFORNIA

Basis: The Concept That Limits Your Losses and Taxes Your Distributions

The Most Misunderstood Number in Pass-Through Taxation

Scenario: A pass-through owner is told a business loss is not currently deductible, or that a distribution is unexpectedly taxable, and wants to understand the basis rules that produced those results.

Executive Summary

Basis is your tax investment in your business interest. It is the meter that determines two things: how much loss you can deduct, and whether a distribution is tax-free. Basis rises with income and contributions and falls with losses and distributions. When it hits zero, further losses are suspended and further distributions become taxable. Most unpleasant surprises in pass-through taxation — a disallowed loss, a taxable distribution — trace back to basis, and yet it is the number owners are least likely to track.

Key point

Basis is not your capital account and not your bank balance. It is a running tax figure. You cannot deduct losses below zero basis (§1366(d) for S corporations; §704(d) for partnerships), and a distribution exceeding basis is taxable gain. Tracking it from year one prevents both problems.

How Basis Moves

Increases basis	Decreases basis
Capital contributions / purchase price	Distributions
Share of income (ordinary and separately stated)	Share of losses and deductions
Additional capital invested	Nondeductible expenses

The ordering matters: income increases basis *before* distributions and losses reduce it, which affects how much of each is tax-free or deductible in a given year.

The Two Loss Limitations Basis Sits Within

Basis is the *first* of a stack of loss limitations. A pass-through loss must survive all of them to be deductible now:

- **Basis limitation.** No loss beyond your investment — §1366(d) (S corp) or §704(d) (partnership).
- **At-risk limitation (§465).** No loss beyond the amount you have economically at risk.
- **Passive activity limitation (§469).** Losses from activities you do not materially participate in are deductible only against passive income.

A loss blocked at any level is suspended and carried forward until basis, at-risk amount, or passive income frees it.

The Critical Partnership–S Corporation Difference

This difference is worth real money. In a **partnership**, a partner's basis includes a share of the entity's liabilities under §752 — so partnership debt can create basis and let a partner deduct losses funded by borrowing. In an **S corporation**, entity-level debt does *not* give shareholders basis; only a *direct* loan from the shareholder to the corporation creates debt basis. An S corporation shareholder who guarantees a bank loan, but does not lend directly, generally gets no basis from it. This single rule frequently determines whether a loss is deductible, and it surprises owners who assume the two forms work the same way.

When Basis Turns a Distribution Taxable

Distributions are tax-free only to the extent of basis. Once cumulative distributions exceed your basis, the excess is taxable — capital gain in most cases. A profitable owner who distributes more than the business has earned, or who has eroded basis through prior losses, can trigger gain on what feels like simply taking their own money out. Tracking basis is what warns you before that happens.

Why Owners Must Track It Themselves

S corporation shareholders are required to maintain their own stock and debt basis and, in loss or distribution years, to file **Form 7203** with their return. Partnerships report a capital account on the K-1, but the tax capital shown there is not always the same as tax basis. In both cases the burden of an accurate, cumulative basis schedule falls on the owner — and reconstructing years of it after the fact, at a sale or under audit, is painful and error-prone.

Practical Considerations

Build a basis schedule the year you acquire the interest and update it every year from the K-1 — contributions, income, distributions, losses, in the correct order. If you need losses funded by entity borrowing in an S corporation, structure the financing as a direct shareholder loan rather than a mere guarantee. Keep the schedule with your permanent tax records; it is indispensable at exit.

Next Step: Reconstruct and Maintain Your Basis

A current, well-documented basis schedule ensures your losses stay deductible and your distributions stay tax-free — and prevents a nasty surprise when you sell. If yours is incomplete, rebuilding it now, while the records exist, is far easier than at the point of a transaction.

Natalie C. Papagni, CPA • Tax, Planning & Advisory Services • 4275 Executive Square, Suite 200, La Jolla, CA 92037 • (858) 754-8277 • service@lajollataxcpa.com • lajollataxcpa.com

Discuss your situation with Natalie C. Papagni, CPA

If you'd like your basis reconstructed and maintained so your losses stay deductible and your distributions stay tax-free, a complimentary initial consultation is the natural first step.

Natalie C. Papagni, CPA — Tax, Planning & Advisory Services

Office	4275 Executive Square, Suite 200, La Jolla, CA 92037
Phone	(858) 754-8277
Email	service@lajollataxcpa.com
Web	www.lajollataxcpa.com