Larry's Tax Law

Understanding the Basis Adjustment Rules is Paramount for S Corporations

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Barnes v. Commissioner, 712 F.3d 581 (D.C. Cir. 2013) *aff'g* T.C.M. 2012-80 (2012) is illustrative of the point that understanding the basis adjustment rules is vital.

If this case was made into a movie, the name of the movie would tell the entire story - S corporation shareholders are not allowed to just make up the basis adjustment rules! Also, as I have repeatedly stated, poor records lead to disastrous results. The DC Circuit affirmed the US Tax Court in April of 2013 to finally put an end to the case.

Marc and Anne Barnes, husband and wife, are entrepreneurs. They were engaged in several businesses, including restaurants, nightclubs and entertainment promotion. These businesses were operated through a sole proprietorship and several entities they owned 100% of, including two S corporations and a C corporation.

The tax returns at issue were the 2003 returns. One of the Barnes' S corporations was Whitney Restaurants, Inc. which operated a Washington DC restaurant and nightclub called Republic Gardens (Whitney has since sold Republic Gardens). Upon audit of the Barnes' 2003 tax return, the Service pulled in the 1120S of Whitney Restaurants.

In addition to some smaller items, the Service disallowed a $123,006 loss stemming from Whitney on the ground the Barnes' had insufficient basis to take the losses. In addition, the Service assessed an IRC Section 6662 accuracy related penalty and an IRC Section 6651 late filing penalty.

The Barnes' contested the assessment, including the penalties, and filed a petition in the US Tax Court. Prior to the court's ruling, however, they conceded liability for the late filing penalty. The return was eight months late. So, the Court was left to decide whether the assessment of taxes and the accuracy related penalty were appropriate.

The facts are a little convoluted. In 1995, the Barnes' had a $22,282 loss from Whitney, suspended due to lack of basis. On their 1996 joint return, they reported the $22,282 loss even though their 1996 K-1 showed an additional $136,229 loss for the tax year. In 1997, they contributed $278,000 in capital to Whitney, enabling them to finally take the suspended losses from 1995 and 1996, which totaled $158,511, but in fact they only deducted the current 1997 loss of $52,594 on the 1997 return. **USER ERROR!**

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To follow the story, we must fast forward to 2003. The taxpayers awake from the sleep they were in and with the help of a new accountant, they determine they should have deducted the losses on the 1997 return. Guess what; that year is closed. **Ouch!**

Sounds bad; but, the Barnes' find a way to relieve some of the pain. They claim, since they did not use the basis for the losses from 1995 and 1996, they can take a deduction for the losses resulting from the current year on the current return - tax year 2003 — using the unused basis from 1997. They make three arguments in favor of this position:

First, they argue IRC Section 1367(a)(2)(B) only requires you to reduce basis for losses you actually report on your return. So, since they did not take the losses on the 1997 return, there should be no reduction in basis. **WRONG!**

IRC Section 1367(a)(2)(B) requires an S corporation shareholder to reduce stock basis by any losses that a shareholder should have taken into account under IRC Section 1366(a)(1)(A), even if the shareholder did not actually claim the benefit of the pass-through of the losses on his/her return.

Next, the Barnes' argued the tax benefit rule allowed them to claim a deduction in 2003 for the loss they should have deducted in 1997. **WRONG AGAIN!**

The tax benefit rule generally only applies when taxpayers recover amounts they deducted in a prior year. When that situation arises, the taxpayer may exclude the recovered income to the extent the prior deduction did not give rise to a tax benefit. The tax benefit was inapplicable in the Barnes case.

Last, the Barnes argued that their failure to properly deduct the losses in 1997 caused them to compute an incorrect amount of losses that could be used to offset income in 2003. I do not understand the argument. It makes no sense. Guess what, the Tax Court did not understand it either. The Barnes' lose the battle!

The Barnes' do not go down for the count. Instead, they turn on their CPA and claim they relied upon professional advice. So, no penalties for accuracy or negligence are appropriate. Unfortunately, the court concluded they did not provide evidence to show they acted in good faith in relying upon professional advice. In fact, the evidence showed the accounting firm's advice was limited by the Barnes' inadequate accounting records and erroneous basis information from prior years in which it did not represent the taxpayers.

The result is simple: The Barnes' were stuck with the tax and penalty assessment and a boat load of interest as the case muddled through the IRS and the court system for over nine years.

There are two pearls of wisdom to take away from the case:

- You reduce stock basis by the losses allowable under IRC Section 1366 even if you fail to report the losses on your return; and

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- If a taxpayer does not provide you with adequate records, they will not likely prevail in a dispute over negligence or accuracy related penalties.

CPAs and other tax advisors need to be careful. You want to resist the temptation to represent or continue to represent clients that do not maintain adequate records.

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Authored by

Larry J. Brant

Principal|Portland

503.553.3114 larry.brant@foster.com

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