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OUTSIDE COUNSEL

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Utilization of S Corporation Losses

Corporate income or loss of a Subchapter S corporation passes through to its shareholders, who report such gain or loss on a pro rata basis.[1] In the event of corporate loss or deduction, special rules apply, which limit the shareholder's utilization of these tax benefits.

One of the most significant limitations is that the aggregate amount of losses and deductions taken into account by the shareholder cannot exceed the sum of the adjusted basis of the shareholder's stock in the corporation plus the adjusted basis of any indebtedness of the corporation to the shareholder.[2] Losses and deductions will act to reduce the shareholder's basis in stock and indebtedness. Sufficient detailed records must therefore be maintained to allow the computation of these items on a cumulative basis.

This article discusses some of the computational rules and recent developments.

The S corporation shareholder computes basis in stock and indebtedness to the corporation utilizing specific rules. The beginning point is the shareholder's initial basis in the stock, which will be the purchase price, gift basis, or inherited basis, as applicable. The shareholder's initial basis in the S corporation stock depends upon how the corporation was formed. It will generally equal the adjusted basis of any property plus the amount of money contributed to the capital stock of the company.

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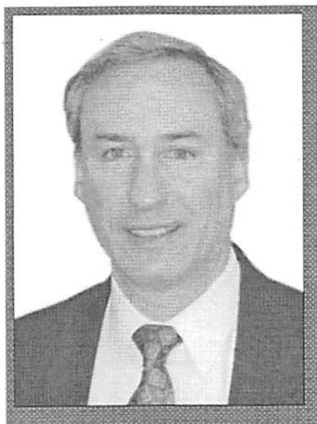

Such initial basis is increased and decreased by the S corporation's items of income, loss or deduction, which are passed through to the shareholder.[3] The shareholder's basis of the S corporation stock is increased by the shareholder's pro rata share of the corporation's income (including tax exempt income).[4] Separately reported items of income will also increase the stock basis.[5] Generally, a per share, per day computation is determined in the event of admission or termination of an interest.[6]

Conversely, stock basis will be decreased by distributions, the shareholder's pro rata share of the separately stated loss and deduction items, and the shareholder's pro rata share of the nonseparately stated loss items.[7] The timing of these basis adjustments usually occurs at the close of the corporation's taxable year.

One of the key adjustment principles is that a shareholder may not reduce stock basis below zero.[8] However, a shareholder with a zero stock basis may recognize further losses to the extent of the shareholder's basis in debt to the S corporation, which shall include the shareholder's advances to the corporation.[9] A shareholder must reduce debt basis (not below zero) to the extent that the shareholder's pro rata share of losses exceeds the shareholder's stock basis.[10]

One of the central differences between an S corporation and a partnership is that the S corporation shareholder is more limited in claiming basis to absorb S corporation losses. The determination of basis is essential because the deductibility of S corporation losses are limited to the sum of the adjusted basis of the shareholder's stock in the S corporation and the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder.[11]

Perhaps the area of most conflict arises in the computation of shareholder basis in indebtedness of the S corporation to the shareholder. A partner in a partnership may receive basis for partnership debt. However, an S corporation shareholder is more limited and will not receive basis in corporate debt. Under the special rules for deductibility of S corporation losses, the shareholder's adjusted basis for debt will only include any indebtedness of the S corporation to the shareholder.

Recent Decisions

Numerous court cases have helped to define the acceptable parameters for basis utilization and provide significant guidance to practitioners in structuring their clients' financial affairs. Only certain debt will provide basis, and it generally seems that these rules create more traps for the unwary or inattentive. For example, a mere shareholder guarantee will not be sufficient to provide the S corporation shareholder basis in the corporation's debt to a third party. Although lenders will often require shareholder guarantees, it would be more pru-

dent, if losses are anticipated (or possible), to have the shareholder directly borrow from the institution as the primary lender and then lend the money to the S corporation.[12]

In order to provide basis, the statute requires debt of the corporation to the shareholder and cases have seldom relaxed this threshold. These rules are highly form-specific. In one case, taxpayer basis was not increased by an exchange of notes from the corporation to the shareholder in order to present the shareholder as primary lender. Penalties were assessed for lack of disclosure.[13] It would be more advisable to have the shareholder incur new debt and to loan the funds to the corporation in order to extinguish the old debt, but this may also be challenged.

In a rare instance, however, the U.S. Court of Appeals for the Eleventh Circuit determined that a shareholder guarantee essentially represented the primary obligation on the loan.[14] The facts of *Selfe* are unusual and distinguishable from most situations, and other circuits have declined to follow its holding. Accordingly, it is advisable to pay careful attention to the acceptable form of the transaction.

The lines continue to blur in instances where debt is transferred from one entity to another or to the S corporation shareholders. Several recent cases have provided some additional guidance. Back-to-back loans are a continual source of litigation and, in several cases, proper and careful record keeping has served to relieve the taxpayers from assessments. For instance, such loans would occur when wire transfers are made from profitable entities to the S corporation shareholders, who then make direct loans to the loss corporation. In *Sid Paul Ruckriegel*, transfers were made by wire from profitable entities directly to the shareholders who then loaned the funds to the S Corporation.[15] Good accounting records were maintained from inception supporting the intent to create loans to the taxpayers from the profitable entities. Good record-keeping prevailed, but the taxpayers were forced to litigate and prove loan history. Other loans made directly from the profitable entities to the loss corporation failed to provide basis.

In contrast, a recent case allowed an increase to shareholder basis for distributions from profitable S corporations directly to a loss corporation.[16] Again, good record-keeping saved the day. The distributions were consistently shown on the corporate book of accounts as loans to the shareholder and such characterization was consistent with all bank financing reports and financial statements. However, the burden of proof rests with the petitioner taxpayer to demonstrate the factual support. It is safer to have such payments come directly from the shareholder.

Numerous cases have defined acceptable parameters for basis utilization and provide guidance to practitioners in structuring clients' financial affairs. Only certain debt will provide basis, and it seems that these rules create more traps for the unwary.

A recent case, *Maloof v. Commissioner*, highlights the fact that if the S corporation is the primary obligor, shareholder basis will not be increased, despite the existence of a shareholder guarantee and the pledge of significant personal assets. The Internal Revenue Service (IRS) asserted that the pledge did not create a substantial economic outlay sufficient to allow basis to be increased.[17] The court required an economic outlay by the taxpayer/shareholder. The IRS will hold the taxpayer to the form, and not substance, of the transaction. These rules are generally a trap for the unwary due to the fact that the taxpayer is generally able to initially structure the loans as a direct loan from the shareholder to the corporation. Banks and financial institutions will often understand the tax reason to structure the loan as a direct borrowing by the shareholder so that the shareholder may effectuate the second step of the transaction by loaning such funds directly to the corporation.

However, in one recent case the IRS decided to press this issue even further.[18] In *Gleason*, although the taxpayer did everything according to the statutory requirements, he was still forced to prove that his loans to the corporation provided basis. The IRS went out of its way to try to recharacterize a direct loan properly made by the taxpayer to the S corporation, simply because the payments on the loan were being made by the corporation and because the stock was pledged as collateral. Relying on its recent victory in *Maloof*, the IRS asserted that a pledge is not sufficient to create basis in the loan and failed to consider the fact that the taxpayer was the primary borrower from the bank (and then loaned the funds to the S corporation). Although the Tax Court properly refused to grant the IRS such sweeping power to obliterate long standing statutory interpretation, the case illustrates just how aggressive the IRS will be if the losses are significant.

In structuring corporate debt, taxpayers have various alternatives. As we have been discussing in this article, the direct loan of funds from the taxpayer to the S corporation is one statutorily provided method. Another method might be to consider utilization of the qualified subchapter S subsidiary, which may be an effective way to offset losses from the loss corporation against profits from a profitable S corporation while still maintaining the protection of separate and distinct legal entities. Provided a proper election is made, a corporate holding company may be established to hold 100 percent of the outstanding shares of the S subsidiary corporations. Losses and income will pass directly through to the parent.[19]

Proposed Regulations

On April 12, 2007 the IRS issued proposed regulations which require certain adjustments be made to basis of shareholder indebtedness. The regulations relate to shareholder open account debt, which includes shareholder debt not evidenced by separate written instruments. The regulations provide that repayments and advances of open account debt will be treated as a single indebtedness.

However, the definition of open account debt in the proposed regulations has been restricted to include only debt in which the aggregate outstanding principal balance does not exceed $10,000.

Taxpayers must maintain a running daily balance of advances and repayments in order to determine if the outstanding indebtedness exceeds the principal amount of $10,000 on any day during the year. Once the $10,000 threshold is exceeded, that principal amount of indebtedness is treated as a separate indebtedness for the remainder of that taxable year and for subsequent years. The indebtedness is no longer treated as open account debt and is subject to the basis adjustment rules as provided in the regulations. The purpose of the new regulations is to prevent corporate shareholders from repaying loans immediately after year-end and then re-establishing them before the end of the year in order to establish basis. Debt which is not open-account debt is accounted for separately. Income first restores the reduced debt basis and then restores the shareholder's stock basis.[20] If separate debt with reduced basis is repaid by the corporation prior to such restoration, gain will result.

In one recent Tax Court case, *Brooks v. Commissioner*,[21] the taxpayers advanced money to their S corporation on open account on several different occasions. These advances were made in December, just before year-end, in order to provide basis for the deductibility of losses. Immediately thereafter, in January of the next year, the company would repay the advances to the taxpayer. The issue was whether the advances provided sufficient basis to offset significant corporate losses. The IRS asserted that the debt should be treated as separate annual advances with no remaining basis due to the claimed losses; therefore, the repayment resulted in capital gain. The taxpayer asserted that the debt was an open-account debt and therefore aggregated at year-end.

When loans are used to absorb losses, a shareholder must reduce the basis of the debt to the extent of the losses (but not below zero); and when the indebtedness is repaid prior to the restoration of such basis, gain will result.[22] Different shareholder loans or advances which are not open-account debt are treated independently and are not aggregated. Therefore, repayments of separate debt prior to restoration will result in gain.[23]

The issue presented in *Brooks*, however, was whether the multiple advances and repayments constitute open-account indebtedness and are therefore treated as a single indebtedness, rather than separate indebtedness. The Tax Court determined that, since the parties had stipulated that the debt was open-account debt, the advances and repayments made during the year should be netted at year's end, and therefore, income was not required to be recognized.

The new $10,000 limitation is the IRS's response to *Brooks* and will present a significant roadblock to taxpayers wishing to provide circular loans and repayments to their S corporation. As a response to *Brooks*, however, the regulations appear premature, since the IRS stipulated the debt was open-account debt and did not make any argument that each large advancement at year-end represented a separate loan transaction.

When the regulations are finalized, taxpayers will be required to maintain computations and account for shareholder loans and repayments. If at the end of the tax year a net repayment exists, the new repayment must be taken into account effective as of the close of the S corporation's tax year. Any net advances are combined with the outstanding aggregate principal balance and carried over to the succeeding year. If at any time during the tax year the aggregate balance of the debt exceeds $10,000, the entire principal amount of the debt will no longer constitute open-account debt. The outstanding balance is reconciled as of that day to determine the aggregate principal amount of the debt. Such open-account debt is then treated as a separate and distinct obligation as if the debt were evidenced by a written agreement.

Conclusion

S corporation loss utilization includes a complex analysis of various historical factors. It is often necessary to find records from the corporation's inception in order to support the computations. Proof of shareholder loans is required and the mere showing of journal entries is usually insufficient on audit.

Advisers must inform their clients of the correct statutory requirements and help their clients maintain the proper structure for loan transactions. In most instances, the client is able to structure loans in the required form and banks and other lenders are often willing to modify loan programs to accommodate these requirements. Good communication and accurate projections are essential. All too often, the tax requirements of loss financing and basis requirements are ignored until it becomes difficult or impossible to correct the mistakes.

This article is intended to help practitioners become aware of the technical requirements in order to assist their clients in choosing the proper form for loan transactions. A small structural adjustment and good record keeping might make a tremendous difference in result.

1. IRC §1366(a).
2. IRC §1366(d)(1).
3. IRC §1367.
4. IRC §1367(a)(1).
5. IRC §1367(a)(1)(A).
6. IRC §1377(a).
7. IRC §1367(a)(2).
8. IRC §1367(a)(2).
9. IRC §1366(d)(1); 1367(b)(2)(A); Treas. Reg. 1.1367-2(b).
10. Treas. Reg. §1.1367-2(b).
11. IRC §1366(d).
12. See generally *Estate of Leavitt v. Commissioner*, 90 T.C. 206 (1988), aff'd, 875 F.2d 420 (4th Cir. 1989), cert. denied, 110 U.S. 367 (1989).
13. *Bhatia v. Commissioner*, T.C. Memo 1996-429 (Sept. 24, 1996).
14. *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985).
15. *Sid Paul Ruckriegel*, TCM 2006-78 (April 18, 2006).
16. *Culnen v. Commissioner*, TCM 2000-139 (April 13, 2000).
17. *Maloof v. Commissioner*, T.C.M. 2005-75 (April 6, 2005).
18. *Gleason v. Commissioner*, T.C. Memo 2006-191 (Sept. 11, 2006).
19. IRC §1361(b)(3).
20. Treas. Reg. §1.1367-2(c).
21. *Brooks v. Commissioner*, T.C. Memo 2005-204 (Aug. 25, 2005).
22. *Smith v. Commissioner*, 48 T.C. 872 (1967), aff'd 424 F.2d 219 (9th Cir. 1974).
23. *Cornelius v. Commissioner*, 494 F.2d 465, 476 (5th Cir. 1974); Treas. Reg. §1.1367-2(a).

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