

## **Inadequate Tax Basis: Leveraging Basis Rules for S Corporations**

Analyzing Guaranteed Loans, Incorporated Pocketbook Theory, and Back-to-Back Loans

---

THURSDAY, JANUARY 4, 2018

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

---

Today's faculty features:

Robert S. Barnett, Partner, **Capell Barnett Matalon & Schoenfeld**, Jericho, N.Y.

Joseph C. Mandarino, Partner, **Smith Gambrell & Russell**, Atlanta

Albert Dumauual, Attorney, **Capell Barnett Matalon & Schoenfeld**, Jericho, N.Y.

---

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 10.**

**NOTE: If you are seeking CPE credit, you must listen via your computer – phone listening is no longer permitted.**

## *Tips for Optimal Quality*

FOR LIVE EVENT ONLY

---

### Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial 1-866-320-7825 and enter your PIN when prompted. Otherwise, please send us a chat or e-mail [sound@straffordpub.com](mailto:sound@straffordpub.com) immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press \*0 for assistance.

**NOTE: If you are seeking CPE credit, you must listen via your computer – phone listening is no longer permitted.**

### Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

## *Continuing Education Credits*

FOR LIVE EVENT ONLY

---

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For CPE credits, attendees must participate until the end of the Q&A session and respond to five prompts during the program plus a single verification code. In addition, you must confirm your participation by completing and submitting an Attendance Affirmation/Evaluation after the webinar.

For additional information about continuing education, call us at 1-800-926-7926 ext. 35.



# Inadequate Tax Basis: Leveraging Basis Rules for S Corporations

Joseph Mandarino  
January 4, 2018

Smith, Gambrell & Russell, LLP  
Promenade II, Suite 3100  
1230 Peachtree Street, N.E.  
Atlanta, Georgia 30309  
[www.sgrlaw.com](http://www.sgrlaw.com)

# Disclaimer

## **IRS CIRCULAR 230 DISCLOSURE:**

Unless explicitly stated to the contrary, this outline, the presentation to which it relates and any other documents or attachments are not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.

1. Why Stock and Debt Basis Matters for S Corporations
2. S Corporations Are Not Partnerships
3. IRS Final Regulations on Basis of Shareholder Debt
4. Incorporated Pocketbook Theory

# Why Stock and Debt Basis Matter for S Corporations

- A shareholder's basis in the stock an S corporation is relevant for at least three reasons:
  - to compute gain/loss on a sale of such stock
  - to determine whether and to what extent a non-dividend distribution is taxable, and
  - to determine whether the shareholder can take a pass-through loss of the S corporation
- Often the last reason is the most important.
- Note that at-risk limitation is applied first, then basis limitation and then PAL. In this seminar we assume away any issues related to the at-risk limitation.

# Why Stock and Debt Basis Matter for S Corporations

- Like partnerships, S corporation owners can only take a pass-through loss if they have sufficient basis.
- If a shareholder has insufficient basis, all or part of the loss is suspended until (if ever) an event occurs that increases the shareholder's basis.
- A suspended loss:
  - Cannot be utilized against a subsequent sale of the S corporation stock, and
  - Is not a tax attribute that carries over to the subsequent purchaser.

# Why Stock and Debt Basis Matter for S Corporations

- Key – if a shareholder terminates his or her interest in an S corporation then any suspended losses disappear.
- Exceptions/caveats -- this rule does not apply to:
  - a transfer between spouses or incident to a divorce,
  - a stock sale taxed as an asset purchase, or
- Also, if a shareholder sells some but not all of his or her stock, then all the suspended losses are retained (there is no pro-rata reduction).

# S Corporations Are Not Partnerships

- In a partnership, the debt of the partnership is allocated to the partners and increases their basis.
- This layer of debt basis can often be used to increase a partner's outside basis so that a loss allocation is not limited.
- Similarly, this layer of basis can be used so offset gain from a distribution of property.
- Unfortunately, S corporations are different.

# S Corporations Are Not Partnerships

- The S corporation rules provide that losses and deduction cannot exceed the sum of:
  - the shareholder's basis in the stock of the S corporation, plus
  - the shareholder's basis in and debt of the S corporation owed to the shareholder.
- Accordingly, debt of an S corporation that is not owed to the shareholder does not create basis.

# S Corporations Are Not Partnerships

- The relevant rules require that any pass-through losses and deductions are first applied against a shareholder's stock basis.
- Only after stock basis is reduced to zero are losses and deductions applied against debt basis.
- Once debt basis is reduced to zero, the basis limitation applies and the losses and deductions become suspended losses.

# S Corporations Are Not Partnerships

- Note that an S corporation's separately stated items of income and gain and non-separately stated income work generally cause an increase in stock basis.
- However, if there have been reductions in the basis of shareholder debt due to pass-through losses and deductions, then these items first are applied to restore that debt basis before being applied to increase stock basic.
- There are many ways to increase stock basis, but we focus for now on debt basis.

# S Corporations Are Not Partnerships

- There are many ways to increase stock basis, but we focus for now on debt basis.

# IRS Final Regulations on Basis of Shareholder Debt

- The key language is “the shareholder’s adjusted basis of any indebtedness of the S corporation to the shareholder.”
- There have been so many attempts by taxpayers to come within this definition that the IRS has issued specific regulations interpreting this provision

# Requirement of Bona Fide Debt

- The IRS regulations require that in order for any debt of the S corporation to a shareholder to qualify under within the §1366(d)(1)(B) such debt must be bona fide indebtedness.
- For debt to be “bona fide” is determined under general Federal tax principles and depends upon all of the facts and circumstances.
- The regulations do not provide any guidance on these principles or on what facts and circumstances are relevant.

# Requirement of Bona Fide Debt

- In general, the case law has established that the following factors tend to indicate that a debt instrument should be treated as bona fide:
  - written evidence of the debt, such as a properly executed note or loan agreement (journal entries alone not enough)
  - a fixed repayment schedule and maturity date
  - interest is charged and is set at a market rate
  - the S corporation provides collateral (typically a security interest in its assets)
  - a history of actual payments in accordance with the schedule and demand for payment occurs if a payment is missed
  - the books and records of both the borrower and the lender treat the obligation as debt.

# Shareholder Guarantee

- The IRS regulations specifically provide that a shareholder does not obtain basis in a debt “merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity.”
- This is the exact opposite of the rule for partnerships. Providing a guarantee generally converts a partnership debt into a recourse debt that is allocated to the partner who provides the guarantee.
- This a common trap for the unwary and there are dozens of cases in which taxpayers attempt to argue that a guarantee gives them basis in debt.

# Payments on A Guarantee Do Create Basis

- While merely providing a guarantee does not create basis, the regulations do provide that any payments made pursuant to a guarantee do create basis and specifically create debt basis.
- Interestingly, the regulations could have taken the position that such payments should be treated as capital contributions and thus create stock basis.
- Arguably, the position in the regulations may relate to the fact that in every state a guarantor steps into the creditor's shoes with respect to the debtor to the extent of any guarantee payments. Thus, such a payment is properly viewed as creating debt from the S corporation to the shareholder.

# Payments on A Guarantee Do Create Basis

- While merely providing a guarantee does not create basis, the regulations do provide that any payments made pursuant to a guarantee do create basis and specifically create debt basis.
- Interestingly, the regulations could have taken the position that such payments should be treated as capital contributions and thus create stock basis.
- Arguably, the position in the regulations may relate to the fact that in every state a guarantor steps into the creditor's shoes with respect to the debtor to the extent of any guarantee payments. Thus, such a payment is properly viewed as creating debt from the S corporation to the shareholder.

# Planning Opportunity?

- If an S corporation is in financial distress, the creditor may not care whether it is paid through a guarantee or by the S corporation itself.
- Assume a shareholder has provided a guarantee on a loan and is preparing to make a substantial payment.
- If the shareholder would prefer that credit for the payment end up in his or her stock basis, the payment can be structured as a capital contribution.
- Conversely, if the shareholder would prefer that credit for the payment end up in his or her debt basis, the payment can be structured as a payment through the guarantee.

# Direct Loan Requirement

- The regulations are clear that to come within §1366(d)(1)(B), a debt must run “directly to the shareholder.”
- If a shareholder makes a loan in his or her own name to the S corporation, and the loan is a bona fide debt, then it should qualify under §1366(d)(1)(B).
- What if the loan is made from an entity that is wholly-owned by the shareholder?

# Example – Controlled Entity Loan

- Jane is the sole shareholder of Newco, an S corporation.
- Jane is also a shareholder of Holdco, an LLC that has elected to be a C corporation.
- Jane causes Holdco to loan \$100 to Newco.
- This loan, even if bona fide, will not create basis for Jane under the regulations
- Same result if Holdco is an LLC that elected to be a partnership or an LLC that elected to be an S corporation.

# Example – Controlled Entity Loan

- However, if Holdco is a single member LLC that elected to be a disregarded entity, then the loan is treated as a direct loan from Jane.
- Under these facts, assuming the loan is bona fide, Jane should get debt basis.

# Example – Controlled Entity Loan

- Same facts as before – assume Holdco is an LLC that has elected to be a C corporation.
- Jane causes Holdco to loan \$100 to herself and then makes a direct loan to Newco.
- Provided the steps are respected and the loan is treated as bona fide, this loan could create basis for Jane under the regulations.
- See discussion slides below on back-to-back loans.

# Debt/Equity Re-Characterization

- There are many, many cases addressing whether an instrument should be re-characterized from debt to equity for tax purposes.
- The analysis often utilizes “factor” analysis. That is, several factors that denote debt-like qualities are considered and if the instrument in the case has more of these factors than equity factors it is adjudged to be debt.
- In recent years a significant alternative or additional basis of analysis is a form of economic substance. That is, equity is characterized as having upside and downside (i.e., participates in corporate growth and is the first to reflect corporate loss), while debt is more insulated.

# Debt/Equity Re-Characterization

- In some instances, the factors that would cause a debt instrument to flunk being “bona fide” debt would also cause it be re-characterized as equity for tax purposes.
- If an instrument is so re-characterized, what effect does this have?
- Often, if there is an actual economic outlay associated with an instrument, then re-characterizing the instrument as equity will result in a stock basis increase, rather than a debt basis increase.

# Debt/Equity Example

- Jane is the sole shareholder of Newco, an S corporation.
- Jane transfers \$100 to Newco pursuant to a written agreement. Under that agreement, Newco is required to pay Jane back with \$10 interest. There is not scheduled repayment or maturity date.
- Assume the IRS is successful in arguing that this instrument is not bona fide debt.
- Even in that case, Jane should be able to argue that if it is not bona fide debt then it is equity.

# Debt/Equity Example

- Accordingly, although Jane would not be entitled to debt basis, the \$100 would be added to the basis of her stock.
- Note that because the basis is attributable to a transfer and not to income items of Newco, it would not be first allocated to restore any basis of “true” debt.
- But, has Jane proven too much?

# Debt/Equity Example

- Recall that the rules governing S corporations prohibit a “second call of stock”.
- Here, the instrument that is reclassified as equity looks a lot like preferred stock. If Newco has only ever issued common stock, Jane’s attempt to convert the instrument into equity could back fire – the IRS could argue that Newco’s S election terminated the day it issued the preferred stock to Jane.

# Debt/Equity Example

- Assume now that the terms of the instrument do not require any cumulative return and, if re-characterized as equity, the instrument would be viewed as substantially similar to Newco's existing common stock.
- In that case, it would appear that there would be no risk to arguing for re-characterization, particularly if the instrument did not pass the bona fide debt test.
- However, the IRS could argue that if Jane originally characterized the instrument as a debt obligation, she cannot now claim that it is equity.
- The counter argument is that if a debt instrument is not "bona fide debt," then it should be viewed as equity.

# Debt/Equity Example

- Assume now that the terms of the instrument do not require any cumulative return and, if re-characterized as equity, the instrument would be viewed as substantially similar to Newco's existing common stock.
- In that case, it would appear that there would be no risk to arguing for re-characterization, particularly if the instrument did not pass the bona fide debt test.
- However, the IRS could argue that if Jane originally characterized the instrument as a debt obligation, she cannot now claim that it is equity.
- The counter argument is that if a debt instrument is not "bona fide debt," then it should be viewed as equity.

# Economic Substance

- Generally, it is the IRS that will argue that the economic substance of an arrangement requires that it be treated in a way that disadvantages the taxpayer.
- In some cases, however, the economic substance of a loan is such that the taxpayer may benefit.
- Although as noted the IRS will often argue that the taxpayer cannot later challenge the tax classification of an arrangement, that doctrine should not apply if the taxpayer has always treated an arrangement consistently.

# Economic Substance – Guarantee Example

- Jane is the sole shareholder of Newco, an S corporation.
- Newco is ailing financially. Newco's balance sheet shows assets equal to liabilities. Jane believes that if Newco starts a new production line, it will grow and prosper, but not bank will lend to Newco based on Newco's existing financial situation.
- Jane induces a bank to make a \$100 expansion loan by personally guaranteeing the loan.
- From the start, Jane takes the position that because the bank is really looking solely to her to repay the loan, that the loan is really to her personally and that she is re-lending the funds to Newco.

# Economic Substance – Guarantee Example

- Jane and Newco reflect this position consistently in their books and records.
- Assume that Jane never made a payment pursuant to the guarantee, and that Newco made all payments directly to the bank. The books and records of Jane and Newco, however, reflect Newco paying Jane and then Jane paying the bank.
- Years later, the IRS audits Newco and argues that Jane merely guaranteed a loan and, as provided in the regulations, that is not sufficient to create debt or equity basis.

# Economic Substance – Guarantee Example

- Because Jane and Newco have consistently taken the position that in substance the bank loaned \$100 to Jane who in turn loaned \$100 to Newco, Jane should not be barred from arguing this position as a procedural matter.
- Jane argues that because in substance this was a back-to-back loan, there simply is no guarantee for tax purposes and the language in the regulations therefore does not apply.
- *This will be a difficult case to argue.*

# Economic Substance – Guarantee Example

- Note that unless there are competing business interests at play, it is almost always better to borrow the funds directly from the bank and then loan or invest them in the S corporation.
- If it is important for a shareholder to disguise the loan, the second leg can be through a single member LLC of the shareholder that elects to be a disregarded entity.

# Incorporated Pocketbook

- The incorporated pocketbook doctrine runs through several provisions of the Code.
- In general, it occurs when a taxpayer habitually causes a wholly-owned corporation to pay money to third parties on behalf of the taxpayer.
- Taxpayers have argued this doctrine in the debt basis context.

# Incorporated Pocketbook

Recall the example from above:

- Jane is the sole shareholder of Newco, an S corporation.
- Jane is also a shareholder of Holdco, an LLC that has elected to be a C corporation.
- Jane causes Holdco to loan \$100 to Newco.
- Recall that this loan, even if bona fide, will not create basis for Jane under the regulations

# Incorporated Pocketbook

- Assume that Jane can show a pattern of causing Holdco to pay her personal bills and expenses.
- Jane argues that Holdco is an incorporated pocketbook and therefore the loan from Holdco to Newco should be re-characterized as being from Jane to Newco.
- The incorporated pocketbook doctrine has been upheld by courts but is highly fact specific. See, e.g., Culnen, T.C. Memo 2000-139 and Yates, T.C. Memo 2001-280.

# Incorporated Pocketbook

- In both of these cases the incorporated pocketbook was itself an S corporation.
- In Culnen, the taxpayer had a high AAA balance and could have withdrawn funds from his pocketbook on a tax-free basis and made the loans directly.
- In Yates, the taxpayer had the same situation, but actually treated the amounts as distributions to the shareholder for tax purposes, even though the transfers went directly from the pocketbook to the related S corporation.

# Incorporated Pocketbook

- In Ruckriegel, T.C. Memo 2006-571, the court entertained the theory but found that the entity in question did not qualify as an incorporated pocketbook because the payments that were arguably made by the entity on behalf of the taxpayers were not numerous enough when compared to the total number of payments.
- Not that in most situations where the taxpayers could argue for an incorporated pocketbook, they would be better off having the pocketbook distribute the funds directly to the taxpayers and then having the taxpayers invest or loan the funds to the S corporation.

# Economic Outlay Doctrine

- In several cases, the courts have argued that the taxpayer is not entitled to any basis credit because no actual economic outlay occurred.
- For example, if a taxpayer borrows \$100 from one S corporation and then loans it to another S corporation, it can be argued that the taxpayer's balance sheet is not changed. In contrast, if the taxpayer borrowed the \$100 from a bank and then loaned it to an S corporation, the IRS would argue that the taxpayer is poorer in a material sense than with the intercompany loans.
- The regulations do not focus on this doctrine. Rather, the regulations appear to require only that the bona fide debt threshold be met.

# Economic Outlay Doctrine -- Example

- Jane is the sole shareholder of Newco and Holdco, both of which are S corporations.
- Jane borrows \$100 from Holdco and then loans it to Newco.
- The regulations state that if Jane's loan to Newco is bona fide debt, then Jane receives basis credit. The regulations do not focus on the economic outlay doctrine and do not appear to consider the loan from Holdco to Jane.
- Treas. Reg. §1.1366-2(a)(2), Ex. 2.



# Thank You

**Joseph Mandarino**

**Smith, Gambrell & Russell, LLP**  
Promenade II, Suite 3100  
1230 Peachtree Street, N.E.  
Atlanta, Georgia 30309  
[www.sgrlaw.com](http://www.sgrlaw.com)  
[jmandarino@sgrlaw.com](mailto:jmandarino@sgrlaw.com)



# S CORPORATION – LOSS UTILIZATION

By Robert S. Barnett  
CPA, JD, MS (TAXATION)

CAPELL BARNETT MATALON & SCHOENFELD, LLP.  
ATTORNEYS AT LAW  
(516) 931-8100  
rbarnett@cbmslaw.com

By Albert Dumauual

CAPELL BARNETT MATALON & SCHOENFELD, LLP.  
ATTORNEYS AT LAW  
(516) 931-8100  
adumauual@cbmslaw.com

# LOSS UTILIZATION

- **IRC §1366(d)(1):** S Corp losses and deductions limited to extent of SH's basis in stock PLUS corporate debt to SH. **Basis determines:**
  - Deductibility of losses and deductions
  - Taxability of distributions
  - Gain/Loss on sale of stock
- Contribution to Capital raises Stock Basis
- **WATCH AT RISK REQUIREMENTS**

# LOSS ORDERING

- First apply At-Risk Rules & Basis
- If Limited by § 465 – not a PAL
- If Insufficient Basis – not a PAL for year
- When Limitations Removed – PAL applies
- **Therefore, must pass Basis & At-Risk Tests**

# RATABLE SHARE

- If part of S loss is disallowed § 1366(d)
- Ratable portion of each S loss item is disallowed
- Permitted to compute limitations on net loss
- Unless individual item taxed differently
- Ex. Part of Passive Rental Activity

# HOW IS BASIS CREATED?

- Purchase / Gift / Inheritance
- Contribute cash or property (less liability assumed) **KEEP RECORDS & RETURNS**
- Accumulated and undistributed **income**
- Tax-exempt income
- Reduced by distributions losses and nondeductible expenses

# INHERITANCE

- §1367(b)(4)(B)
- Reduction of FMV Basis
- By portion of value of stock attributable to IRD

# EXAMPLE

- Inherit 20% S Corp.
- S Corp. fmv \$1 million
- Including \$500k cash A/R
- Basis = \$100k

# REG. 1.1367-1 BASIS

- **Stock Basis** purchase/ gift / inheritance
- Increase by K-1 income items & tax free
- Pro rata – per share per day
- Decrease (**not below 0**) k-1 losses & distributions
- Compute at end of year (or before disposition)

# BASIS CONTINUED

- Contribute property – basis less liability assumed, **WATCH §357(c)**
- **EXAMPLE:** Property Basis \$40,000, Value \$100,000 and mortgage of \$30,000 is contributed: **STOCK – BASIS \$10,000**
- Special Estate Considerations – reduction for IRD type items
- Ordering Rules – will be discussed

# **BASIS DETERMINES**

- Deductibility of losses and deductions
- Taxability of distributions
- Gain/Loss on sale of stock

# LOSS UTILIZATION

- IRC §1366(d)(1)
- **LIMITS** use of S Corp losses and deductions to extent of shareholder's **basis in stock**
- **PLUS** Corporate debt to shareholder.

# LOSSES - UTILIZATION

1. First §1366(d)(1) Stock Basis
  2. Then reduces Basis in debt to Corp
  3. Remainder carried forward
- **REMEMBER** – basis does not include guarantees or circular loans
  - Back-to-Back – must be bona fide
  - *See* §1.1366-2(a)(2)(i) & (iii), ex. 2

# BASIS

- *Barnes v. Comm.*, 111 AFTR 2d 2013 (DC Cir)
- Affirmed Tax Court, **TCM 2012-80** – reduce basis even if fail to deduct the loss
- S SHs inadequate basis
- Unable to deduct losses – limited to basis
- Basis not increased by prior losses not claimed
- Taxpayer failed to deduct suspended losses
- Statute of limitations expired

# LOSS UTILIZATION

- *Gleason v. Commissioner*, TCM 2006-191 (9/11/06)
  - Taxpayer won as borrower on a \$6m loan
  - IRS re-characterized loan properly made by taxpayer because loan payments paid by Corp and stock was pledged as collateral
- *Kerzener*, TCM 2009-76
  - **CIRCULAR LOAN** from p'ship to S SH to S corp did not create basis.
  - S Corp paid equivalent rent back to the p'ship.
  - Transaction **lacked economic substance**
  - **MERE CONDUIT** – No sufficient risk
  - Court distinguished Ruckriegel and Culnen
- *Nathel*, 105 AFTR 2 ¶ 2010-927 (2nd Cir. 6/2/10)
  - Equity and debt are distinguishable
  - Contribution of equity increases basis of stock but does not restore loan basis
  - **CONTRIBUTIONS TO CAPITAL ARE NOT INCOME!**

# ***NATHEL***

- Attempted to restore or increase loan basis
- Corp. repaid shareholder loans with reduced basis (from losses)
- Recognized Ordinary Income on repayment of loan
- Capital contributions do not create exempt income (income increases loan basis)
- Supreme court denied cert.

# *Culnen*, TCM 2000-139

- Distributions from profitable S to loss S added to basis > \$3 Mil:
  - i. amounts came out of S earnings,
  - ii. always shown** on books as loans to/from shareholder, and
  - iii. all bank financing statements showed the loans as personal, not corporate.
- **IRS** permits Back to Back loans (bona fide)

# BACK TO BACK LOANS

- **Prop. Reg. §1.1366-2**
- “Bona fide indebtedness”
- All facts & circumstances considered
- General tax principles
- ***MAGUIRE***, TCM 2012-160
  - Auto dealer and finance company
  - Finance A/R distributed then contributed

# BONA FIDE DEBT

- Watch Second Class of Stock Rules
- Straight Debt Safe Harbor
- Reg. §1.1361-1(1)(5)

# DEBT v. EQUITY

- Transfers to Corp generally equity, not loan
- Capital contribution
- **Corp's payment of personal expenses = dividends**
- Not repayment of loan
- No debtor/creditor indicia
- *ACM Environmental Services*, TCM 2012-335
- **Proper documentation missing**

# NOT BONA FIDE DEBT

- No Bad Debt Deduction –*Herrera v. Comm’r*, 112 AFTR2d 2013-6858 (5th Cir.)
- LLC (partnership) Loans to related steel corp.
- No written promissory notes
- No definite maturity
- No repayment schedule
- No security – no payments

# OPEN ACCOUNT DEBT INTRODUCTION

- *Brooks v. Commissioner* –  
TCM 2005-204 (August 25,  
2005)
- **Final Regulations**

# LOANS

- Assume Stock Basis \$100
- If X \$200 loss, shareholder deducts only \$100
- §1366(d)(1) deductions limited to Basis
- **Basis can never be negative**
- So shareholder loans \$100 to Corp on 12/31
- Stock Basis & Loan Basis is **\$0**
- Later income first restores Loan Basis

# OPEN ACCOUNT DEBT

- Shareholder loans/advances not evidenced by written instrument
- New Regulations – advances 10/20/08 and thereafter
- Limit \$25,000 per Shareholder
- **EXAMPLE** – Each Sh. can have up to \$25,000 of Open Account Debt

# BE CAREFUL

- No Shareholder exceeds limit
- Keep records per Shareholder
- Not day/day – END OF S YEAR
- Unless debt disposed or Shareholder terminated

# WHAT HAPPENS

- When \$25,000 limit exceeded
- Debt at end of year treated **AS IF** evidenced by separate written agreement
- No longer Open Account Debt
- Debt existing on 10/20/2008 is not subject to new rules and is treated as a separate loan
- Identification issues exist

# LOSSES – ORDERING RULES

- Losses first absorb Stock Basis
- Then reduce Debt Basis
- **NOT BELOW ZERO**
- Multiple indebtedness – Loss Allocated
- Based upon aggregate Basis
- Intricate record keeping required

# RESTORATION

- Distinction between Stock & Debt Basis
- “Net Income” restores Debt Basis first
- “Net Increase” is §1367(a)(1) income items
- New contribution(s) - increase Stock Basis (*Nathel*)
- Computations generally determined at **end of the year**

# COMPUTATION

- Advances and Repayments are netted
- At close of S Corp year
- Net Advance or Repayment is combined with Principal balance of Open Account Debt
- Carried to next year (unless  $> \$25,000$ )
- IF  $> \$25,000$  – no longer Open Account Debt
- Treated as if separate debt.

# EXAMPLE ONE

- A's Stock Basis is \$0
- 6/1/09 A loans S \$16,000 (no note)
- 12/31/09 – Open Account Debt = \$16,000

# EXAMPLE TWO – 2009

## STOCK BASIS \$0

- A lends \$16,000 6/1/09
- 12/31/09 Loss <\$8,000>
- A's BASIS in Open Account Debt is \$8,000
- Principal Loan amount remains \$16,000

# EXAMPLE THREE – 2010

- A Stock Basis = \$0 Loan Basis = \$8,000 (principal \$16,000)
- 4/1/10 – S Repays to A \$4,000
- 9/1/10 – A Advances \$1,000 (net \$3,000)
- 12/31/10 – Debt Principal \$13,000
- Still open Account Debt

# EXAMPLE THREE CONTINUED

- **A Ordinary Income \$1,500**  
( $8/16 \times \$3,000$  Net Repayment)
- IF evidenced by note Capital Gain
- Debt treated “as if” evidenced by note,  
tax effect not addressed
- 12/31/10 – Open Account Debt Principal  
\$13,000
- Carried to 2011

# EXAMPLE FOUR (ex. 3 FACTS)

- 2/1/11 – S Repays A \$5,000
- 3/1/11 – A Advances \$20,000
- Not evidenced by a written agreement
- 2011 Net Advance \$15,000
- Debt \$28,000 ( $>$  \$25,000 – not Open Account Debt)
- Treated **as if** evidenced by a separate written agreement – **maintain records**

# REPORTING REQUIREMENTS

- Must keep records per shareholder
- IF hold more than one indebtedness at close of year –
  - Basis is reduced proportionately to aggregate Basis
  - Net increase is applied to first restore debt basis before stock basis
  - First restore Basis of any debt which is repaid during year



# WHO CARES?

- The IRS & the Treasury
- \$25,000 limitation eliminates Year End Repayments
- Mixed blessing
- Gain on Repayment of Debt evidenced by notes is **CAPITAL GAIN**
- Repayment of Open Account Debt with reduced basis = **ORDINARY INCOME**

# ***NATHEL***

- Attempted to restore or increase loan basis
- Corp. repaid shareholder loans with reduced basis (from losses)
- Recognized Ordinary Income
- Capital contributions do not create exempt income (income increases loan basis)
- Supreme court denied cert.

# PLANNING

- Reduce YE Balance < \$25,000
- Use Note – Capital Gain
- Do Not Repay
- Identify Debt Repaid
- Contribute to Capital

# **SCOTT SINGER INSTALLATIONS INC. – TCM 2016-161**

- IRS – payment of personal expenses  
**WAGES**
- TP Advanced \$ to Corp.
- Corp. paid TP's expenses
- TP – Loan repayment not wages
- No Notes or Debt Acknowledgement

# SHAREHOLDER LOAN SUFFICIENT?

- Court Said Yes
- In years Co. was profitable
- In other years No!
- Look at all factors
- Need Debtor/Creditor Relationship

# S CORP DISTRIBUTIONS

- Goals:
  1. Avoid/Defer taxation
  2. Avoid C corp taxation
  3. Preserve S election
  4. Maximize tax-free \$

# **BASIS DETERMINES**

- Deductibility of losses and deductions
- Taxability of distributions
- Gain/Loss on sale of stock

# S CORP DISTRIBUTIONS

- Initial question:
  - Does S corp have **AEP**?
  - **Accumulated Earnings & Profits**
- Next compute Basis

# EARNINGS AND PROFITS (E & P)

- Measures ability to pay Dividends
- Net profits after SH Dividends
- Special adjustments
- Cumulative computations

# Example

- Accumulated deficit of \$20,000
- Current E & P of \$10,000
- Distribution of \$10,000
- Taxable Dividend
- Wait until next year

# **C Corp w/ AEP → S Election**

- C corp has \$100 AEP
- C corp makes S election
- C corp becomes S corp
- S corp has \$100 AEP

# STOCK BASIS DECREASE

- Deductions and Losses
  - NOT below zero
- Distributions
- Nondeductible expenses

# BASIS ADJUSTMENTS

- Per share, per day
- At year end, generally
- First increases, then decreases
- Special election – to close books

# S Corp Distribution – No AEP

- No tax to extent of **Basis**
- **Distribution** → Decrease Basis
- Yearly adjustment
- Distributions > Basis → capital gain
- AAA Irrelevant

# NO AEP – EXAMPLE

- Bob owns all S corp stock
  - Basis = \$10K on 1/1/2015
  
- During 2015:
  - \$30K ordinary loss
  - \$10K distribution

# NO AEP – EXAMPLE

- Distribution = Basis
  - Bob not taxed on distribution
  - Decrease Basis to \$0
- No Basis → \$30K loss suspended

# DISTRIBUTIONS IF AEP

- 4 Tiers:

1. Tax free to **AAA** (**A**ccumulated **A**adjustments **A**ccount, Up to Basis)
2. Dividend to AEP
3. Return of capital – Basis
4. **Excess:** Gain sale or exchange

# AAA (1982)

- Previously Taxed Income
- §1368(e)(1)(A) – corp. attribute
- Computed similar to **Basis**, except:
  - No adjustment for exempt income
  - No adjustment for C level taxes
- **CAN BE LESS THAN ZERO**
  - But not by distributions

# AAA Adjustments

- **INCREASE**
  - Non-separately stated income
  - Separately stated income
- **DECREASE**
  - Non-separately stated loss
  - Separately stated loss
  - Distributions

# AAA Stock Sale/Redemption

- **Stock sale to 3<sup>rd</sup> party:**
  - AAA unaffected
  - AAA affects transferee's distributions
- **Redemption:**
  - Reduces AAA
  - Based on ratio of shares redeemed

# 1<sup>ST</sup>: Net Positive or Net Negative?

- **Net Positive:**

- $(\text{income} + \text{gain}) > (\text{loss} + \text{deduction})$
- NOT including distribution(s)

- **Net Negative:**

- $(\text{loss} + \text{deduction}) > (\text{income} + \text{gain})$
- NOT including distribution(s)

## 2<sup>ND</sup>: Timing

- **Net Positive AAA Adjustment:**
  - Adjust AAA **BEFORE** taxing distribution
- **Net Negative AAA Adjustment :**
  - Adjust AAA **AFTER** taxing distribution
  - Allows more tax-free basis return

## **3<sup>RD</sup>: Default Order**

1. To extent AAA, Capital Return
2. Then Dividend to AEP
3. Then Capital Return to Basis
4. Excess is Capital Gain

# S Corp w/ AEP – Example 1

- **Joan owns 100% S Corp:**

- Basis = \$10K on 1/1/2015

- AAA = \$2.5K

- AEP = \$8.5K

- **In 2015:**

- \$10K income

- \$3K loss

- \$12K distribution

# Example 1 (Net Positive)

	AAA	AEP	S Corp Dist.	C Corp Dist.
<b>Starting</b>	<b>\$2,500</b>	<b>\$8,500</b>		
Increase AAA: <u>net positive</u>	<u>\$7,000</u>			
AAA balance before Dist.	\$9,500			
Decrease: distribution	<u>\$9,500</u>		\$9,500	
<b>Ending AAA</b>	\$0			
Distribution from AEP		<u>\$2,500</u>		\$2,500
Ending AEP		\$6,000		

- Dividend \$2500

# Example 1 Basis

	<u>Basis</u>
Starting	\$10,000
Increase for income	<u>\$10,000</u>
Basis before distribution	\$20,000
Decrease for dist. not taxed as dividend	(\$9,500)
Decrease for losses	<u>(\$3,000)</u>
Ending Basis	\$7,500

- Return of capital \$9500

# Example 1

- \$10K Pos. Adj. > \$3K Neg. Adj.
- \$10K - \$3K = **\$7K** Net Positive Adjustment
- Adjust AAA **BEFORE** taxing distribution
- AAA increased by \$7K → \$9.5K
- **First:** Capital return to extent of AAA
- AAA = \$9.5K; Capital Return of \$9.5K
- AAA decreased by \$9.5K → \$0

# Example 1

- Distribution  $\$12\text{K} - \$9.5\text{K AAA} = \$2.5\text{K}$
- **Second:** Dividend to extent of AEP
- **Remaining**  $\$2.5\text{K} < 8.5\text{K AEP}$
- **Dividend of \$2.5K**
  
- **AEP Adjustment**
- $\$8.5\text{K} - \$2.5\text{K dividend} = \underline{\underline{\$6\text{K}}}$

# Example 1

- **Basis Adjustment**
- \$10K at start
- Increase \$10K income → \$20K
- Decrease \$9.5K capital return → \$10.5K
- Decrease \$3K loss → \$7.5K
- (AAA = 0)

# Example 2 (Net Negative)

- **Sally owns 100% S Corp:**
  - Basis = \$2,000 on 1/1/2015
  - AAA = \$300
  - AEP = \$500
- **In 2015:**
  - \$200 capital gain
  - \$1,000 loss
  - \$2,000 distribution

# Example 2

	AAA	AEP	S Corp Dist.	C Corp Dist.
<b>Starting</b>	<b>\$300</b>	<b>\$500</b>		
Decrease: distribution (not below zero)	(\$300)		\$300	
AAA Balance after dist.	\$0			
Decrease AAA: net negative adjustment	<u>(\$800)</u>			
<b>Ending AAA</b>	<b>(\$800)</b>			
Distribution from AEP		<u>(\$500)</u>		\$500
Ending AEP		\$0		
Dist. in excess of AAA/AEP			\$1200	

# Example 2

	<u>Basis</u>
<b>Starting</b>	<b>\$2,000</b>
Increase for Income	\$200
Decrease for Dist. not taxed as dividend	<u>(\$1,500)</u>
Basis after distributions	<b>\$700</b>
Decrease for losses	(\$700)
<b>Ending Basis</b>	<b>\$0</b>
<b>Suspended losses</b>	<b>\$300</b>

# Example 2

- \$1,000 Neg. Adj. > \$200 Pos. Adj.
  - \$1,000 - \$200 = **\$800 Net Negative Adjustment**
  - Adjust AAA **AFTER** distribution
1. Beginning AAA \$300 distributed TAX FREE!
  2. AAA negative (not Basis)
  3. AAA reduced by full net negative adj.

# Example 2

- **First:** Capital Return to extent of AAA
- AAA = \$300 capital return
- AAA decreases by \$300 → \$0
- THEN apply Net Negative Adjustment
- \$800 Net Negative Adjustment
- Decreases AAA by \$800
- **AAA = -800**

# Example 2

- **Second: Dividend to extent of AEP**
- \$500 of remaining distribution
- Dividend of \$500
- **AEP → 0**
- **Third: Adjust Basis → Capital Return**
- **Remaining \$1,200 of \$2,000 distribution**
- Capital Return of \$1,200 + \$300

# Example 2

- **Basis Adjustment & Suspended Loss**
- Basis = \$2,000 at start
- Increase for \$200 income → \$2,200
- Decrease for \$1,500 Capital Return → \$700 (\$300 AAA + \$1,200 remaining distribution)
- Decrease for \$700 loss → \$0
- **Basis cannot be < zero**
- Remaining \$300 → suspended loss

# Property Distribution

- Similar rules apply
- Distribution = FMV
- Gain as if sold § 311(b)
- Gain to extent FMV exceeds basis
- Gain passes to SH, increases stock basis
- Property Basis = FMV
- SH Basis decreased by property FMV

# Depreciated Property Distribution

- Generally no loss allowed, § 311(a)
- Value of dist. is FMV of property
- SH Basis in property is FMV
- Treated as non-deductible, non-capital expense. **CCA 201421015.**
- AAA & SH Basis reduced by loss
- **Sell Property!**

# Thank You

By Robert S. Barnett

CPA, JD, MS (TAXATION)

CAPELL BARNETT MATALON & SCHOENFELD, LLP.

ATTORNEYS AT LAW

(516) 931-8100

[rbarnett@cbmslaw.com](mailto:rbarnett@cbmslaw.com)

By Albert Dumauual

CAPELL BARNETT MATALON & SCHOENFELD, LLP.

ATTORNEYS AT LAW

(516) 931-8100

[adumauual@cbmslaw.com](mailto:adumauual@cbmslaw.com)