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IRS Regulations Concerning Shareholder Loans to S Corporations

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Overview

When a "sub-chapter S" election is made, a corporation is treated taxwise as an individual. That means all of the corporate income, loss, deduction and other tax items flow through the corporation to the individual shareholder's tax return. So, for example, if the corporation has a loss, that loss is deductible by the shareholders on their personal tax returns. But, the loss is limited by the shareholders' tax basis in their stock. Stock basis is determined by the shareholder's original investment in the corporation's stock plus certain debt basis. Also, the manner in which the shareholder acquires the stock influences basis (e.g., whether it was received as a gift, a purchase, as compensation or through an estate).

Adjustments to Basis

Basis is increased by the shareholder's share of corporate taxable income and any capital contributions the shareholder makes. Basis is decreased by the shareholder's share of corporate losses and any S corporation distributions to the shareholder.

So, a deductible loss reduces the shareholder's basis in the stock at the close of the year. Basis cannot be reduced below zero, and any loss that is not deductible due to the basis limitation is carried forward to the next tax year. It does not expire and may be deducted when the shareholder gains sufficient basis to absorb it.

Shareholder loans. A shareholder can loan money to their S corporation and increase their stock basis by the amount of the loan. But care must be taken. Basis is increased for debts only if there is an actual economic outlay by the shareholder and the S corporation is obligated to pay off the debt. In essence, the loan must have substance and the taxpayer must be "at risk." For example, the U.S. Court of Appeals for the Eighth Circuit, in 2004, affirmed a Tax Court opinion on this issue in a case that involved the owner of a trucking company. [1] The owner had multiple S corporations and borrowed money from one corporation and loaned it to another S corporation with tax losses so he would have basis to deduct the loss on his personal return. The second corporation sent the money immediately back to the first corporation in another loan. The court did not have any trouble holding that the loan did not have any substance and was not "at risk." The result was that the shareholder was not able to deduct losses in the amount of approximately $14 million.

The *Van Wyck*[2] case. An Iowa farmer also learned this lesson the hard way in 1999. He borrowed money from a family member that he farmed with (and who was also a shareholder), paid off the corporate debt, and then contributed the balance to the corporation as a loan. The Tax Court held that the taxpayer's share of corporate losses was disallowed because they were not "at risk."[3] Had he simply borrowed the funds personally and then loaned them to the corporation, he would have been able to increase his stock basis and deduct the losses.

The Tax Court again dealt with this issue in 2005.[4]

In that case, the shareholders had no basis remaining in their shares. So, to be able to claim corporate losses on their individual returns, the shareholders each advanced funds (via two separate loans) to the corporation near year's end. They withdrew the cash contributions near the beginning of the next year, and then loaned the funds back to the corporation to enable them to take more losses. The Tax Court said this procedure worked because only the debt balances at year-end were what mattered. The withdrawal of funds during the year was immaterial. The court held that the multiple advances by the shareholders and repayments by the corporation constituted open account indebtedness. That meant that they were treated as a single indebtedness rather than separate indebtedness. The basis of the indebtedness was, therefore, determined at the end of the year by netting the advances and repayments during the year. By restoring the basis in their debts, the advances that the shareholders made to the S corporation shielded them from realizing gain on debt repayments made during the years at issue. IRS didn't like the Tax Court's decision, but they had little room to complain because their own regulation provides that advances and repayments of open account debt are treated as a single indebtedness for the purpose of making debt basis adjustments and defines open account debt as "shareholder advances not evidenced by separate written instruments and repayments on the advances." [5] That meant that the only date of significance in measuring the basis of the advances is December 31. So, in accordance with the IRS regulation, the Tax Court held that the corporate owners got to take the whole loss, and they didn't have taxable gain on the loan repayment early the next year.

Proposed Regulations

IRS proposed new regulations in April of 2007 designed to wipe out the Tax Court's opinion.[6] In essence, the proposed regulations mirror the approach that IRS took in the case and define open account debt as shareholder advances not evidenced by separate written instruments for which the principal amount of the aggregate advances, net of repayments on the advances, does not exceed $10,000 at the close of any day during the S corporation's tax year. That definition includes separate advances under a line of credit agreement not evidenced by a separate written instrument. The rules split open account debt into multiple loans if the balance of the open account debt exceeded $10,000 during the year. The open account debt on the books would be treated as a loan under a note at the time it went over $10,000, and any additional advances would be treated as a separate loan. That means that open account debt would be measured separately for each advance, on a first-in, first-out basis.

So, how would the proposed rules have impacted the 2005 case had they been in effect at that time? The shareholders still would have been able to deduct the losses in full, but they would also have had a significant capital gain on the repayment of the "deemed" separate debt that they paid off early the next year. That's because the rules would have resulted in two loans instead of a single loan with the balance measured at the end of the year. The rules essentially trigger a "recapture" of the loss claimed in the prior year by virtue of the year-end loan. They also change dramatically the basis in the open account debt.

The proposed rules become final with an effective date of October 20, 2008, Thus, S corporation shareholders must determine whether their advances and repayments exceed the $10,000 aggregate principal threshold. Probably the best way to do that is to maintain a running balance of those advances and repayments and the principal amount of the open account debt.

The new rules have now snagged their first victim. In *Nathel v. Comr*,[7] two brothers loaned funds to their S corporations, enabling them to deduct losses. In a series of transactions they made capital contributions over $1.4 million to the corporations and repaid the loans. The IRS said they had ordinary income on the loan repayment. The taxpayers tried to convince the court to allow them to increase the loan basis by treating the capital contributions as income, but the court disagreed.

Planning Principles

Clearly, the new rules have several implications for S corporations year-end planning. First, if a loss appears likely, taxpayers should determine whether they have enough basis to deduct the loss—taking into account any current year loans and distributions to date. Second, for taxpayers that are considering year-end loans or contributions to

capital, there must be sufficient basis to be able to deduct any resulting losses, and that basis must be "at-risk" and must not violate the passive loss rules. Also, if the taxpayer is making a year-end loan to the S corporation in order to take losses, the loan must stay in place until the S corporation income has restored the taxpayer's loan basis. Otherwise income is triggered upon repayment of the loan. In addition, for taxpayers that have already repaid the loan and now are facing taxable income as a result, do not attempt to restore basis with another loan or capital contribution. Finally, taxpayers must be cautious in using funds from another family-owned entity to finance a loan to the S corporation. The *Nathel*[8] case indicates that if the funds are circled back to where they started, the IRS may be able to strike down the loan as lacking substance.

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[1] Oren v. Comr., 357 F.3d 854 (8th Cir. 2004).
[2] 113 T.C. 440 (1999).
[3] Van Wyk v. Comr., 113 T.C. 440 (1999).
[4] Brooks v. Comr., T.C. Memo. 2005-204.
[5] Treas. Reg. §1.1367-2(a).
[6] Section 1367 Regarding Open Account Debt, 72 Fed. Reg. 18417 (to be codified at 26 C.F.R. pt. 1)(proposed Apr. 12, 2007).
[7] 131 T.C. No. 17 (2008).
[8] 131 T.C. No. 17 (2008).