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S Corporation Shareholder Stock Basis





Objectives

Today we will:

- Identify the three shareholder loss limitations.
- Define when a shareholder has debt basis.
- Identify case law factors used to establish when debt is bona fide.
- Discuss transactions which do not qualify as bona fide shareholder debt.
- Discuss transactions which may qualify as bona fide shareholder debt.

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Reason to Make S Corp Election

Two main reasons for electing S corp status:

1. Avoid double taxation on distributions
2. Allow losses to pass through to its owners

Congress placed limits on the amount of pass-through losses that a shareholder is allowed to claim.





Shareholder's Schedule K-1

The shareholder's Sch. K-1 does **not** state –

- the amount of the loss or deduction items which can be claimed, or
- the amount of the non-dividend distribution which is taxable.



Shareholder Loss Limitations

- There are three shareholder loss limitations:
 1. Stock & debt basis
 Losses should not be reflected on Form 1040
 2. At-risk limitation
 Losses should be reflected on Form 6198
 3. Passive activity limitation
 Losses should be reflected on Form 8582





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Each Year the Shareholder Needs to Know

The amount of –

- Stock basis
- Debt basis
- Suspended losses due to stock & debt basis
- Suspended losses due to at-risk
- Suspended losses due to passive activity limitations





Shareholder Debt Basis

- IRC §1366(d)(1)(B) states that losses are allowed up to the amount of the shareholder's adjusted basis of any indebtedness of the S corp to the shareholder.
- S corp shareholder does not get basis in the third party debts of the entity.





What Qualifies as Indebtedness of the S Corp to the Shareholder?

- Treas. Reg. § 1.1366-2(a)(2)(i)
 - Provides that shareholders obtain basis in indebtedness if the S corp owes a bona fide debt directly to the shareholder.
 - Finalized and effective on July 23, 2014.



Bona Fide Debt Case Law Factors

1. a written instrument,
2. a stated interest rate,
3. a maturity date,
4. an enforceable debt under state law,
5. a reasonable expectation of repayment,
6. creditor remedies upon default; and
7. repayment or other conduct that indicates the parties upheld the terms of the debt.

For additional factors see Notice 94-47.





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Entity Level Debt

- The shareholder does not get basis in third party entity-level debt.
- There is no bona fide debt between the shareholder and the corp.





Loan Guarantees

- Guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity does not give rise to basis in indebtedness.
- Treas. Reg. §1.1366-2(a)(2)(ii)





Payment on Loan Guarantee

- When a shareholder makes a payment on bona fide indebtedness of the S corp for which the shareholder has acted as guarantor or in a similar capacity, then the shareholder may increase the shareholder's basis of indebtedness to the extent of that payment.
- Treas. Reg. §1.1366-2(a)(2)(ii)



Judgment on Default Loan Guarantee

In *Montgomery v. Comm'r*, T.C. Memo 2013-151:

- Judgment was imposed on the shareholder as a result of his loan guarantee.
- Shareholder did not make any payments.
- Shareholder did not become the primary obligor.
- Ruled – Judgment on default does not create debt between the shareholder and the corp so no debt basis is allowed.



Co-Maker or Co-Borrower

- Both the shareholder and corporation borrow from the bank.
- Shareholder owes the bank.
- Corporation owes the bank; corporation does not owe the shareholder.
- No bona fide debt between the shareholder and the corporation so no debt basis allowed.
- *Salem v. Comm'r*, TC Memo 1998-63 aff'd, 196 F.3d 1260 (11th Cir. 1999)



Back to Back Loans

- A back-to-back loan is when a person borrows money from one party and lends that money to another.
- In the case of an S corp, the shareholder usually borrows money and then lends it to his S corp.





Bank Loan to Shareholder followed by Loan to S Corp

- The shareholder is personally liable for the debt and there is bona fide indebtedness from the S corp to the shareholder so debt basis is allowed.
- *Gilday v. Comm'r*, T.C. Memo 1982-242





Related Entity Loans Money to S Corporation

- A shareholder's "Profitable" Corp loans money to the shareholder's "Loss" S Corp.
- "Loss" S Corp does not owe the shareholder anything (there is no bona fide debt between S Corp and shareholder) so debt basis is not allowed.
- Rev. Rul. 69-125.





Loan from Related Party to Shareholder then Loaned to S Corp

- Based on the facts and circumstances, one must determine if there is bona fide debt from S Corp owed to the shareholder. If there is bona fide debt, debt basis is allowed.
- Treas. Reg. §1.1366-2(a)(2)(iii), Example 2.





Restructure of Related Party Loans

- A shareholder's "Profitable" Corp loans money to the shareholder's "Loss" S Corp.
- "Profitable" distributes note to shareholder and the note is now between shareholder and "Loss" S Corp.
- If there is bona fide debt, debt basis is allowed.
- Treas. Reg. §1.1366-2(a)(2)(iii), Example 3.





Distribution from Related Party to Shareholder then Loan to S Corp

- Distribution made from Related Entity to shareholder followed by a contribution from the shareholder to S Corp.
- If a distribution occurred, the shareholder's basis in the related entity has decreased and his basis in S Corp has increased.
- *Maguire v. Comm'r*, T.C. Memo. 2012-160



Circular Flow of Funds

- Generally funds start with one entity, are lent or distributed to other persons and/or entities, and end up with the original entity.
 - May provide the shareholder with debt basis.
 - When the transaction lacks substance or the shareholder is merely a conduit, the shareholder is not allowed debt basis.





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Examples Circular Flow of Funds Lack Substance

Oren v. Comm’r, 357 F.3d 854 (8th Cir. 2004)

Restructured investments where “Profitable” loaned money to Shareholder who loaned money to “Loss” within a few days “Loss” transferred money to “Profitable.”

Kaplan v Comm’r, T.C. Memo 2005-218

Bank loaned money to shareholder. Shareholder loaned money to “Loss,” loss sent money to “Shell Corp”, “Shell Corp” sent money to shareholder who repaid the bank within a few days.





Additional Information

- www.irs.gov – Key word: S Corporation
- Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc. and Instructions to Schedule K-1 (1120S).
- Form 1120S, U.S Income Tax Return for an S Corporation





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