

## LB&I Concept Unit Knowledge Base – S Corporations

Library Level	Number	Title
Shelf		Other Flow Throughs
Book	53	S Corporations
Chapter	53.4	Stock & Debt Basis
Section	53.4.2	Debt Basis
Subsection	53.4.2.1	Valid Shareholder Debt Owed by S Corporation

<b>Unit Name</b>	Valid Shareholder Debt Owed by S Corporation	
<b>Primary UIL Code</b>	1367.02-00	Adjustment to Basis of Stock of, and Indebtedness Owing, Shareholders

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# General Overview

## Valid Shareholder Debt Owed by S Corporation

IRC 1366(d) provides that a shareholder may take losses and deductions to the extent of stock and debt basis. However, unlike rules for partners and partnerships, a third party loan to an S corporation does not increase the shareholder's debt basis. Instead, debt basis for an S corporation shareholder is defined in Treas. Reg. 1.1366-2(a)(ii)(2) as the shareholder's adjusted basis in any bona fide debt of the S corporation owed directly to the shareholder. Whether the debt is bona fide or whether it is owed directly to the shareholder depends upon all the facts and circumstances. This makes debt basis one of the most controversial areas of S corporation law.

In order for a loan to increase a shareholder's debt basis, the shareholder must be the creditor and the loan must be bona fide.

This practice unit addresses what qualifies as bona fide debt and whether that debt is owed directly to the shareholder creating debt basis.

# Relevant Key Factors

## Valid Shareholder Debt Owed by S Corporation

### Key Factors

#### Bona Fide Indebtedness Factors

Whether a debt is bona fide is a facts and circumstances determination. The weight given to each factor varies depending upon the facts of the case. Case law describes factors that include, but are not limited to whether:

1. There is a written instrument,
2. There is a stated interest rate,
3. There is a maturity date,
4. The debt is enforceable under state law,
5. Expectation of repayment is reasonable,
6. The creditor has remedies upon default (security interest or the position of the lender with respect to other creditors), and
7. Repayments were made or the parties complied with the terms of the agreement.

Many court cases address what constitutes bona fide indebtedness. Most Circuit Courts of Appeal list factors used in making this determination. In analyzing whether there is bona fide indebtedness, consider the factors used by the Circuit Court controlling the shareholder's case. Below is a list of cases by Circuit Court. For additional factors, see Notice 94-47.

- *Crowley v. Commissioner* - 962 F.2d 1077 (1<sup>st</sup> Cir. 1992) - 11 bona fide indebtedness factors
- *Fin Hay Realty Co. v. U.S.* - 398 F.2d 694 (3<sup>rd</sup> Cir. 1968) - 16 bona fide indebtedness factors
- *Slappey Drive Industrial Park v. U.S.* - 561 F.2d 572 (5<sup>th</sup> Cir. 1977) - 13 bona fide indebtedness factors
- *Roth Steel Tube Co. v. Commissioner* - 800 F.2d 625 (6<sup>th</sup> Cir. 1986) - 11 bona fide indebtedness factors
- *Busch v. Commissioner* - 728 F.2d 945 (7<sup>th</sup> Cir. 1984) - 7 bona fide indebtedness factors
- *In re Uneco v. U.S.* - 532 F.2d 1204 (8<sup>th</sup> Cir. 1976) – 13 bona fide indebtedness factors
- *A.R. Lantz Co. v. U.S.* - 424 F.2d 1330 (9<sup>th</sup> Cir. 1970) - 11 bona fide indebtedness factors
- *Williams v. Commissioner* - 627 F.2d 1032 (10<sup>th</sup> Cir. 1980) - 8 bona fide indebtedness factors
- *Lane v. U.S.* - 742 F.2d 1311 (11<sup>th</sup> Cir. 1984) - 13 bona fide indebtedness factors

# Relevant Key Factors (cont'd)

## Valid Shareholder Debt Owed by S Corporation

### Key Factors

#### S Corporation Debt Owed Directly to Shareholder

There is no bright line test to determine if the S corporation's bona fide debt is owed directly to the shareholder. As stated in the regulations, whether there is bona fide debt between the S corporation and the shareholder is determined under general Federal tax principles and depends upon all of the facts and circumstances. When analyzing the debtor-creditor relationship, consider if:

1. The proceeds came from the shareholder versus a third party, and
2. The intent of the S corporation is to repay the shareholder.

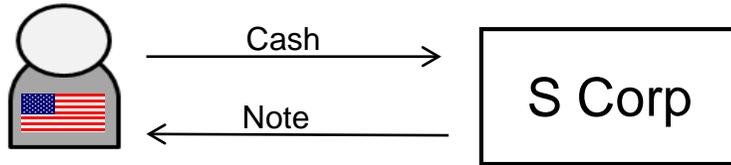
In order for a loan to increase the shareholder's debt basis, the shareholder must be the creditor and the loan must be bona fide. If a loan is from a third party lender, then the third party lender is the creditor, not the shareholder, and the shareholder's debt basis is not increased.

# Diagram of Concept

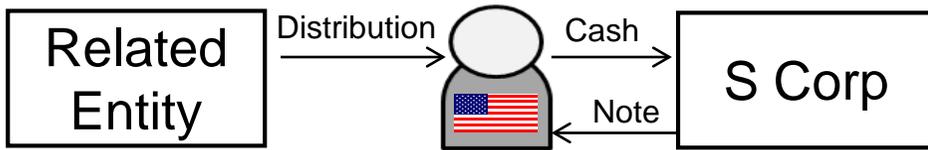
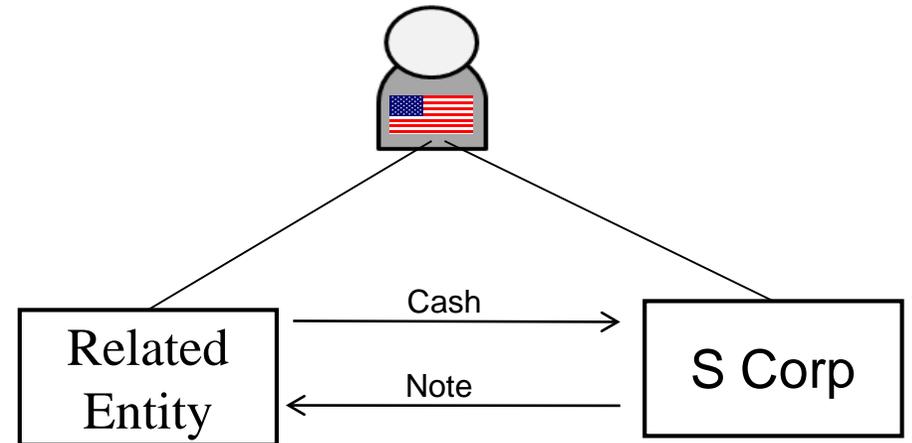
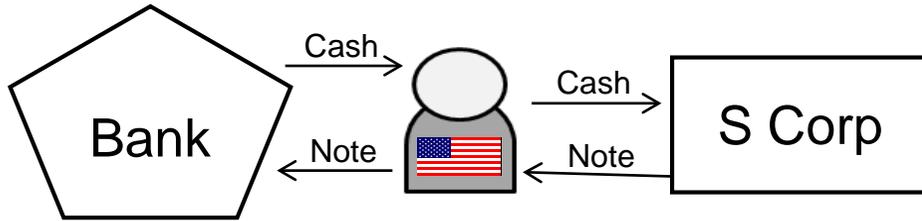
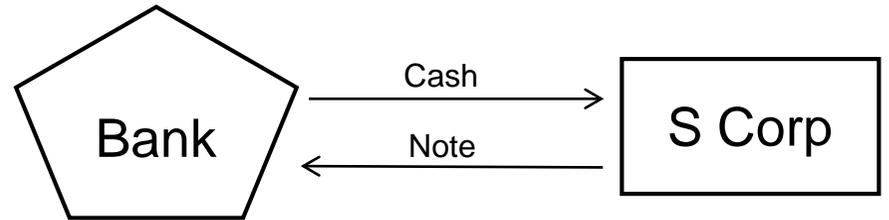
## Valid Shareholder Debt Owed by S Corporation

### Diagram of Concept

Generally Creates Valid Debt Basis



Does Not Create Valid Debt Basis



# Detailed Explanation of the Concept

## Valid Shareholder Debt Owed by S Corporation

In order for a loan to increase a shareholder's debt basis, the shareholder must be the creditor and the loan must be bona fide.

Analysis	Resources
<p><u>Loan Guarantees</u></p> <p>Shareholders often guarantee the corporation's third party debt. The corporation's name is on the loan, with the shareholder signing as a guarantor in case the S corporation defaults. In these cases, the guarantee itself does not create debt basis for the shareholder because there is no loan between the shareholder and the corporation. A shareholder is not allowed debt basis for merely guaranteeing the corporation's debt.</p> <p>However, when a shareholder repays a debt of the S corporation for which the shareholder has acted as a guarantor or in a similar capacity, the shareholder may increase debt basis to the extent of that repayment.</p> <p>It is important to note that the new regulations (effective July 23, 2014) do not affect the prior judicial determinations related to shareholders guaranteeing S corporation debt. These well-established doctrines are applicable before and after the new regulations.</p> <p><u>Judgment on Default of Loan Guarantee – No Basis</u></p> <p>When an S corporation defaults as the primary obligor on its loan obligation and a judgment is imposed on the shareholder as a result of a guarantee, the judgment does not create a debt between the shareholder and the S corporation. Therefore, a judgment on default does not create debt basis.</p>	<ul style="list-style-type: none"><li>▪ Treas. Reg. 1.1366-2(a)(2)(ii)</li><li>▪ See <a href="#">Examples of the Concept #1</a></li> <li>▪ Treas. Reg. 1.1366-2(a)(2)(iii)</li><li>▪ Rev. Rul. 70-50</li><li>▪ See <a href="#">Examples of the Concept #2</a></li>  <li>▪ <i>Montgomery v. Commissioner</i> - T.C. Memo. 2013-151</li></ul>

# Detailed Explanation of the Concept (cont'd)

Valid Shareholder Debt Owed by S Corporation	
Analysis	Resources
<p><u>Co-Making or Co-Borrowers</u></p> <p>In a co-making or co-borrowing loan transaction, a third-party lender requires both the S corporation and the shareholder to sign the loan as the borrowers. Therefore, both the S corporation and the shareholder are liable to the third-party lender.</p> <p>A shareholder's debt basis is not increased in a co-making or co-borrowing situation. This is because the co-borrowed amount is not debt the S corporation owes to the shareholder; rather both the shareholder and the S corporation owe the third-party lender. Since the S corporation and the shareholder have not entered into debtor-creditor relationship, the shareholder's debt basis is not increased.</p> <p>Court cases addressing co-borrowing should be considered since this issue is not specifically addressed in the regulations.</p>	<ul style="list-style-type: none"><li>▪ <i>Salem v. Commissioner</i> - T.C. Memo. 1998-63 (1998) aff'd, 196 F 3d 1260 (11<sup>th</sup> Cir. 1999)</li></ul>

# Detailed Explanation of the Concept (cont'd)

Valid Shareholder Debt Owed by S Corporation	
Analysis	Resources
<p><u>Debt Basis Allowed</u></p> <p>A shareholder receives basis if the shareholder borrows money from an unrelated party, such as a bank, and then lends the money to the S corporation.</p> <p> <b>CAUTION:</b> Subsequent to an examination, the corporation's debt may be restructured in order to make the shareholder personally liable for the third-party debt. Assuming the restructuring creates a bona fide loan from shareholder to the S corporation, the shareholder's debt basis is increased in the year of restructuring, but not in the year of the audit.</p> <p><u>Back-to-Back Loans and Related Party Debts</u></p> <p>A back-to-back loan occurs when a person borrows money from one party and then lends that money to another. Debt basis is allowed for back-to-back loans from related parties assuming a debtor-creditor relationship exists between the S corporation and the shareholder, with the S corporation being the debtor and the shareholder being the creditor.</p> <p> <b>CAUTION:</b> When dealing with related party back-to-back loans, it is important to see how both the entity lending the funds and the S corporation borrowing the funds booked the transaction on their financial statements. The shareholder may claim to have debt basis in the S corporation, yet the related entity's books reflect "Due from Affiliate" on its balance sheet.</p>	<ul style="list-style-type: none"><li>▪ <i>Gilday v. Commissioner</i> - T.C. Memo. 1982-242</li><li>▪ Treas. Reg. 1.1366-2(a)(2)(iii)</li></ul>

# Detailed Explanation of the Concept (cont'd)

Valid Shareholder Debt Owed by S Corporation	
Analysis	Resources
<p><u>Back-to-Back Loans and Related Party Debts (cont'd)</u></p> <p> <b>CAUTION</b> (cont'd): If done properly, the S corporation should show a payable to the shareholder. This is reflected on line 19 of the Form 1120S balance sheet, Loan from Shareholder. If, instead, the S corporation shows a payable to the related entity on its balance sheet, that is an indication that it may not be shareholder debt as the funds did not come from the shareholder and are not due to the shareholder.</p> <p>Do not simply rely on the S corporation's balance sheet when auditing this issue. Follow the flow of the transaction and determine how the transaction was recorded. Review the S corporation's general ledger and see which general ledger account(s) record the payable. In addition, request a copy of any loan agreements evidencing the S corporation's payable. If the balance sheet shows a Loan from Shareholder, but the loan agreement shows it is due to another party, the shareholder may not be the creditor. If the shareholder is in fact not the creditor, then the loan amount does not increase the shareholder's debt basis.</p> <p>If the related entity shows a receivable due from the S corporation, that is a key indicator that the related entity is the creditor, and not the shareholder. In order for the Loan from Shareholder to be respected on the S corporation's books, the related entity's books and records must show that the shareholder received the funds either through a loan or a distribution.</p> <p>Review the entire transaction and confirm that both the related party and the S corporation reflect the transaction consistently.</p>	<ul style="list-style-type: none"><li>▪ Form 1120S - <i>U.S. Income Tax Return for an S Corporation</i></li></ul>

# Detailed Explanation of the Concept (cont'd)

Valid Shareholder Debt Owed by S Corporation	
Analysis	Resources
<p><u>Distributions from a Related Entity to the Shareholder</u></p> <p>A distribution from a related entity to the shareholder and then a loan from the shareholder to an S corporation may be sufficient to allow the shareholder debt basis.</p> <p>In <i>Maguire v. Commissioner</i>, the shareholder owned two S corporations; one was profitable (Profitable Entity) and the other was in a loss situation (Loss Corporation). Loss Corporation borrowed funds from Profitable Entity; thus Profitable Entity carried a receivable owed by Loss Corporation on its balance sheet.</p> <p>The shareholder was unable to claim pass-through losses from Loss Corporation, because the shareholder did not have sufficient basis. Consequently, the shareholder directed Profitable Entity to distribute the receivable from Loss Corporation to the shareholder, who then contributed it to Loss Corporation, effectively canceling the note.</p> <p>The court held that the shareholder's stock basis in Loss Corporation was increased by the receivable contributed, which had been previously distributed to the shareholder from Profitable Entity. At the conclusion of the transaction, the shareholder's basis in Profitable Entity was reduced and his basis in Loss Corporation was increased.</p> <p>On the other hand, if the shareholder personally kept the receivable, instead of contributing it to Loss Corporation, the corporation and the shareholder would have a debtor-creditor relationship. Assuming that the debt is bona fide, the shareholder's debt basis would increase by that amount, based on Example 3 of Treas. Reg. 1.1366-2(a)(2)(iii).</p>	<ul style="list-style-type: none"><li>▪ Treas. Reg. 1.1366-2(a)(2)(iii)</li><li>▪ <i>Maguire v. Commissioner</i> - T.C. Memo. 2012-160</li></ul>

# Detailed Explanation of the Concept (cont'd)

Valid Shareholder Debt Owed by S Corporation	
Analysis	Resources
<p><u>Circular Flow of Funds</u></p> <p>A circular flow of funds involves a series of transactions in which funds pass through entities or individuals and are ultimately returned to the originating entity. In other words, the funds circle back to the originator. If this occurs within a short timeframe, for example several days, it may be appropriate to develop facts concerning the business purpose and economic substance of the transactions to determine if they increase the shareholder's basis.</p> <p>Historically, court cases ruled that circular flows of funds do not create shareholder debt basis. However, the preamble of the current regulations states that certain circular cash flows may increase a shareholder's debt basis. Nonetheless, transactions that lack economic substance or transactions in which the shareholder is merely a conduit do not increase debt basis.</p> <p><u>Loan from Shareholder – Asset Sale or Redemption of Stock</u></p> <p>It is not uncommon for a shareholder to sell assets to his S corporation and report the gain on the sale under the installment method. Additionally, it is not uncommon for the corporation to redeem a shareholder's stock and issue a note to the shareholder in exchange for the stock. The installment method is an accounting method for reporting gains (not losses) from the sale of property when at least one payment is received in a tax year after the year of sale; that is, there are deferred payments.</p>	<ul style="list-style-type: none"><li>▪ Treas. Reg. 1.1366-2</li><li>▪ IRC 453</li><li>▪ Issue Snapshot - Installment Method – General Rules</li></ul>

# Detailed Explanation of the Concept (cont'd)

Valid Shareholder Debt Owed by S Corporation	
Analysis	Resources
<p><u>Loan from Shareholder – Asset Sale or Redemption of Stock (cont'd)</u></p> <p>Under the installment method, gain from the sale is prorated and recognized over the years in which payments are received. As a result, each payment received usually consists of interest, return of basis, and gain on the sale. The gain recognized each year is equal to the payments received during the year times the gross profit percentage.</p> <p>If a sale qualifies for the installment method of reporting gain, the transaction is reported on Form 6252, <i>Installment Sale Income</i>, which is attached to the Form 1040. In addition, the use of the installment method automatically applies unless the taxpayer elects out. The taxpayer elects out of the installment method by reporting all the gain as income in the year of sale. A taxpayer must make an election no later than the due date for filing the taxpayer's return (including extensions) for the year in which the sale occurs.</p> <p>One of the reasons installment sales reporting was created was to relieve taxpayers from having to pay tax on the entire gain in the year of sale when in fact they had only received cash for a portion of the sales price. Therefore, when the S corporation issues a note to the shareholder to purchase the asset, the S corporation and the shareholder essentially enter into a debtor-creditor relationship, which may increase the shareholder's debt basis in the S corporation.</p>	<ul style="list-style-type: none"><li>▪ IRC 1366</li><li>▪ Form 6252 - <i>Installment Sale Income</i></li><li>▪ See <a href="#">Examples of the Concept #3</a></li></ul>

# Detailed Explanation of the Concept (cont'd)

Valid Shareholder Debt Owed by S Corporation	
Analysis	Resources
<p><u>Loan from Shareholder – Asset Sale or Redemption of Stock (cont'd)</u></p> <p>Under IRC 453B(b), the basis of an installment obligation equals the excess of the face value of the obligation (the remaining principal amount) over an amount equal to the income which would be returnable were the obligation satisfied in full (the remaining unreported gain). This results in the shareholder's basis in the note being equal to the shareholder's remaining basis in the property sold.</p> <p><u>Single Member LLC Lends or Contributes Money to the S Corporation</u></p> <p>Under the check-the-box provisions, a single member limited liability company (SMLLC) is automatically treated as a disregarded entity unless an election is made to be treated as a corporation. For tax purposes, a SMLLC entity is disregarded and its activity is treated as the individual owner's activity. Therefore, if the SMLLC lends money to the individual's S corporation, it is treated as if the individual personally lent the money. Assuming it is valid indebtedness, the loan creates debt basis for the shareholder.</p>	<ul style="list-style-type: none"> <li>▪ IRC 453B</li>   <li>▪ IRC 1366(d)(1)(B)</li> <li>▪ Treas. Reg. 1.1366-2(a)(2)(iii), Example 1</li> </ul>

# Examples of the Concept

## Valid Shareholder Debt Owed by S Corporation

### Examples

#### Example 1 – Shareholder Loan Guarantee

Rich, the sole shareholder in an S corporation, guaranteed the corporation's outstanding debts of \$50,000. Rich's basis in the corporate stock is zero and the corporation had operating losses of (\$70,000) for the year.

As guarantor of the corporation's debts, Rich only has a contingent liability. Therefore, Rich cannot include the \$50,000 of corporate indebtedness in his basis and, thus, cannot deduct any of the (\$70,000) loss on his current year individual tax return.

#### Example 2 – Payment by Shareholder on Loan Guarantee

Assume the same facts as in Example 1 except that in Year 2 Rich pays \$30,000 of the \$50,000 debt owed by the corporation. Upon Rich's payment, the corporate debt becomes an obligation to Rich under the Doctrine of Subrogation, and he can now include the payment of \$30,000 as part of his debt basis in Year 2. However, he is still not allowed to claim debt basis for the remaining \$20,000 outstanding corporate loan until he pays the debt.

#### Example 3 – Basis of Note Receivable from Installment Sale

Carl, the 100% shareholder sells land to his S corporation on July 14 of Year 1 with the following attributes:

Sales Price	1,000,000
Adjusted Basis of Land	<u>250,000</u>
Gain on Sale	750,000
Gross Profit Percentage	75%

# Examples of the Concept (cont'd)

## Valid Shareholder Debt Owed by S Corporation

### Examples

#### Example 3 – Basis of Note Receivable from Installment Sale (cont'd)

At the date of sale, the S corporation gave Carl \$100,000 cash and a note for \$900,000. Carl reports the following gain during Year 1:

Amount Received	100,000	
Gross Profit Percentage	<u>75%</u>	
Reportable Gain	75,000	
Remaining Basis in Note	225,000	(250,000 – 25,000)

Another Method:

Remaining Face Amount	900,000	(1,000,000 – 100,000)
Remaining Unreported Gain	<u>675,000</u>	(750,000 – 75,000)
Remaining Basis in Note	225,000	

Carl's basis in the note (i.e., Loan from Shareholder) is equal to his remaining basis in the installment obligation, which is \$225,000. As a result, Carl could claim pass-through S corporation losses up to \$225,000 against his debt basis. Note that the \$900,000 face amount of the note is not Carl's basis in the note since Carl has not reported the remaining \$675,000 (750K – 75K) deferred gain.

As the installment note is repaid by the S corporation, the shareholder's basis in the note will also decrease. Also, the \$75,000 reported gain will not increase the shareholder's debt basis as that gain has to do with the receipt of the \$100,000 cash and not with pass-through S corporation income.

Once the initial basis in the note has been established, the shareholder can now use that debt basis to claim S corporation losses in excess of stock basis. Claiming the losses will reduce the shareholder's basis in the note.

# Index of Referenced Resources

## Valid Shareholder Debt Owed by S Corporation

IRC 453

IRC 453B

IRC 1366

Treas. Reg. 1.1366-2

Rev. Rul. 70-50

Notice 94-47

Form 1120S - *U.S. Income Tax Return for an S Corporation*

Form 6252 - *Installment Sale Income*

*Montgomery v. Commissioner* - T.C. Memo. 2013-151

*Salem v. Commissioner* - T.C. Memo. 1998-63 (1998) aff'd, 196 F 3d 1260 (11<sup>th</sup> Cir. 1999)

*Gilday v. Commissioner* - T.C. Memo. 1982-242

*Maguire v. Commissioner* - T.C. Memo. 2012-160

*Crowley v. Commissioner* - 962 F.2d 1077 (1<sup>st</sup> Cir. 1992)

*Fin Hay Realty Co. v. U.S.* - 398 F.2d 694 (3<sup>rd</sup> Cir. 1968)

*Slaphey Drive Industrial Park v. U.S.* - 561 F.2d 572 (5<sup>th</sup> Cir. 1977)

*Roth Steel Tube Co. v. Commissioner* - 800 F.2d 625 (6<sup>th</sup> Cir. 1986)

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*In re Uneco v. U.S.* - 532 F.2d 1204 (8<sup>th</sup> Cir. 1976)

*A.R. Lantz Co. v. U.S.* - 424 F.2d 1330 (9<sup>th</sup> Cir. 1970)

*Williams v. Commissioner* - 627 F.2d 1032 (10<sup>th</sup> Cir. 1980)

*Lane v. U.S.* - 742 F.2d 1311 (11<sup>th</sup> Cir. 1984)

# Training and Additional Resources

Valid Shareholder Debt Owed by S Corporation	
Type of Resource	Description(s)
Issue Toolkits	<ul style="list-style-type: none"><li>▪ Audit Tool – S Corporation Corporate Issues and Advanced Topics Issue Guide</li><li>▪ Audit Tool - S Corporation Shareholder Loss Limitation Issue Guide</li><li>▪ Audit Tool – S Corporation Stock &amp; Debt Issue Guide</li><li>▪ Audit Tool - Stock &amp; Debt Basis Worksheet Tools</li><li>▪ Audit Tool - FAQs – Basis &amp; Loss Limitations</li><li>▪ Issue Snapshot - Installment Method – General Rules</li></ul>
Reference Materials – Treaties	<ul style="list-style-type: none"><li>▪ <i>Practitioners Publishing Company (PPC) - 1120S Deskbook</i></li></ul>

# Glossary of Terms and Acronyms

Term/Acronym	Definition
SMLLC	Single Member Limited Liability Company

# Index of Related Practice Units

Associated UIL(s)	Related Practice Unit	DCN
1367.01-00	<i>Initial Stock Basis</i>	SCO/C/53_4_1_1-01(2016)
1367.00-00	<i>Adjustments to Stock Basis</i>	SCO/C/53_4_1_2-02(2016)
1367.01-00	<i>Stock Basis Ordering Rules</i>	SCO/C/53_4_1_3-03(2016)
1367.00-00	<i>Adjustments to Debt Basis</i>	SCO/C/53_4_2_2-05(2016)