S Corporation Corner

By Nelson A. Toner

The Shareholder's Loan to the S Corporation–Debt Basis

In my last *S Corporation Corner* column, I mentioned that I have recently been approached by several tax practitioners to help them with S corporation audits by the IRS. The previous article focused on S corporation stock basis, a significant topic of review in these audits. In this column, I will turn my attention to another important topic of review—a shareholder's loan of funds to the S corporation. The topic of debt with respect to an S corporation is remarkably broad, and I will not attempt to cover all aspects of this topic. For example, the Treasury has recently proposed amendments to the regulations to define when a loan from a shareholder to an S corporation can be included in the shareholder's debt basis. In addition, a shareholder's debt may be considered a second class of stock if it contains significant equity features. Rather, the focus of this article will be narrowed to focus on the determination of the shareholder's adjusted tax basis in the debt, a particularly prickly series of calculations that have stymied some of my colleagues around town.[1]

The General Rules for Determining Debt Basis

For each tax year of the S corporation, the shareholder can only deduct losses and expenses allocated to the shareholder up to the amount of the shareholder's adjusted basis in his or her stock (called "stock basis" for the purposes of this article) and debt (called "debt basis" for the purposes of this article).[2] By making a loan to the S corporation, the shareholder increases the amount of losses that can be deducted. Thus, it is important to correctly determine the shareholder's

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debt basis each year. Although the determinations of stock basis and debt basis have common components, they also contain different components. It is a tax practitioner's knowledge of these differences between the calculations that provides the proper framework for the tax practitioner to understand the debt basis rules and to explain them sufficiently to the client.

An understanding of the determination of debt basis begins with knowledge of three preliminary rules concerning the relationship between stock basis and debt basis. First, distributions, losses and deductions reduce stock basis to zero and any excess losses and deductions reduce debt basis.[3] Thus, stock basis is first reduced to zero and then debt basis is reduced. Second, once debt basis has been reduced in any prior year, debt basis is restored by any "net increase" (a concept that will be described later) in a later year before the stock basis is increased.[4] Thus, in any tax year where there is a "net increase," debt basis is restored first and then stock basis is increased. Finally, debt basis cannot be reduced below zero and cannot be restored to more than the outstanding principal balance of the loan.[5]

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When a shareholder loans money to an S corporation, the shareholder's initial debt basis is the amount of the loan. In order to aid in the understanding of the concepts concerning the determination of debt basis, I will use an example throughout this article. With respect to each loan made to the S corporation, the loan is evidenced by a written promissory note and the corporation is authorized to borrow the funds from the shareholder by corporate resolution.

Example (1): In early January of year one, Fred forms Y Corporation; Fred is the sole shareholder. Y Corporation timely elects S corporation status effective from its date of incorporation. Fred contributes $100x to Y Corporation soon after the corporation is formed. In the first tax year, Y Corporation has $70x of losses that are allocated to Fred that reduce his stock basis to $30x. At the beginning of the second year, Fred loans $50x to Y Corporation. When Fred makes the loan to Y Corporation, he has a debt basis of $50x.

The Internal Revenue Code ("the Code") and the regulations contain specific rules concerning the reduction of debt basis. Once the basis of the shareholder's stock is reduced to zero by items of loss, expense and deduction listed in Code Secs. 1367(a)(2)(B), (C), (D) and (E), then any excess of these items is applied to reduce the shareholder's debt basis. Similar to the rule for stock basis, a shareholder's debt basis cannot be reduced below zero.[6] In general, this reduction rule applies to any debt held by the shareholder at the end of the tax year of the corporation.[7] However, if the shareholder terminates his or her equity interest in the S corporation during the tax year, then the rules for the reduction of debt basis are applied to any debt held by the shareholder immediately prior to the sale of all of his or her equity interest.[8]

The Code and the regulations also contain specific rules concerning the restoration of debt basis. If a shareholder's debt basis has been reduced in a prior tax year, then any "net increase" in a later tax year will be used to restore the shareholder's debt basis. For these purposes, the "net increase" with respect to a shareholder is the excess of the items of income in Code Sec. 1367(a)(1) over the items of loss, deduction and expense, and distributions, all as described in Code Sec. 1367(a)(2). The restoration rules only apply to debt held by the shareholder at the beginning of the tax year.[9] Therefore, in any year that there is a net increase, the net increase is first used to restore the shareholder's debt basis. If the debt basis is restored to the face amount of the debt, then any remaining net increase restores the shareholder's stock basis.

With respect to the reduction of debt basis and restoration of debt basis, the amounts of the adjustments to a shareholder's debt basis are determined at the end of the S corporation's tax year. In general, these adjustments are effective at the same time. However, these general timing rules concerning the effective date of these adjustments are modified if the shareholder sells all of his or her stock in the S corporation prior to the end of the tax year or the corporation repays in whole or in part the shareholder's debt. If the shareholder sells all of his or her stock in the S corporation during the tax year, then these adjustments are effective immediately before the shareholder terminates his or her equity interest. If the S corporation repays the loan in whole or in part during the tax year, the basis of the debt is restored effective immediately before the full payment or the first payment of the debt in the tax year if the corporation is only repaying a part of the debt.[10]

If the shareholder's basis in his or her debt is reduced in a prior year and is not fully restored in a later year when the corporation repays a portion or all of the debt, then the repayment of any portion of the debt is a taxable event to the shareholder.[11] The difference between the amount of the payment from the corporation and the shareholder's basis in the debt (if the debt is fully repaid), or in an allocable portion of the basis of the debt (if only a portion of the debt is repaid), is gain to the shareholder.[12]

Example (2): In the example started above, in the second year, Y Corporation has $40x of losses that are allocated to Fred. Fred has a stock basis of $30x. At the end of the tax year, Fred holds a debt with a debt basis of $50x. His stock basis is reduced by the amount of losses until his stock basis is zero. The excess losses of $10x are then applied to reduce his debt basis from $50x to $40x.

Example (3): In the third year, Y Corporation has $50x of the items of income in Code Sec. 1367(a)(1) and $20x of the items of loss, deduction, expense and distribution in Code Sec. 1367(a)(2). At the beginning of the third year, Fred held a debt with a debt basis of $40x. No payments on the debt are made to Fred. Y Corporation has a net increase of $30x (the excess of the income items over the items of loss, deduction, expense and distribution). The $30x net increase is applied first to the debt basis to restore it to $50x, the initial amount loaned to Y Corporation. The remaining net increase of $20x is applied to Fred's stock basis.

Digging Deeper into the Debt Basis Rules

These apparently straightforward rules for reduction and restoration of debt basis can have some interesting consequences when applied in more complicated situations. In particular, the rules create a unique relationship between the rules for distributions to the shareholder and the rules for the restoration of debt basis. In addition, special rules apply when a shareholder has made more than one loan to the S corporation. Both of these situations arise with regularity in the audits where I have been asked to help.

The debt basis modification rules create a connection between a distribution to a shareholder and a restoration of the shareholder's debt basis that can be understood by carefully reviewing several stock basis and debt basis rules. First, a shareholder's debt basis has no effect on the amount of tax the shareholder will recognize from a distribution from the S corporation. If an S corporation has no C corporation earnings and profits, then the amount of any distribution in excess of the shareholder's stock basis is treated as capital gain. This same rule is incorporated into the calculation of tax with respect to a distribution from an S corporation with C corporation earnings and profits.[13] Second, the reduction of debt basis is not affected by a distribution to the shareholder. As stated above, the reduction of debt basis occurs when the negative adjustments under Code Secs. 1367(a)(2)(B), (C), (D) and (E) exceed the positive adjustments under Code Sec. 1367(a)(1) and such excess is greater than the shareholder's stock basis. A distribution to the shareholder under Code Sec. 1367(a)(2)(A) is not part of the equation. Finally, the restoration of debt basis is affected by a distribution to the shareholder. The determination of the "net increase" takes into account all of the positive adjustments under Code Sec. 1367(a)(1) and all of the negative adjustments under Code Sec. 1367(a)(2), including any distribution to the shareholder under Code Sec. 1367(a)(2)(A). Here are two comparative examples concerning the application of these rules.

Example (4): Picking up the facts from the end of Example (2) above, at the end of the second year, Fred's stock basis is zero and his debt basis is $40x. The face amount of the debt is $50x. During the third year, the sum of the items of income under Code Sec. 1367(a)(1) is $20x, and the sum of the items of loss, deduction and expense under Code Secs. 1367(a)(2)(B), (C), (D) and (E) is $10x. In the third year, Y Corporation made a distribution to Fred of $15x. The Y Corporation did not make any payment to Fred on his debt. The distribution to Fred must be taken into account to determine if there has been a "net increase" in the third year. When the distribution is taken into account, there is no "net increase" because the amount of items under Code Sec. 1367(a)(1) do not exceed the amount of items under Code Sec. 1367(a)(2). Therefore, none of Fred's debt basis is restored in the third year. Rather, the $20x of items under Code Sec. 1367(a)(1) are applied to increase Fred's stock basis to $20x. Under Code Sec. 1367(a)(2)(A), the distribution of $15x reduces Fred's stock basis to $5x.[14] The distribution is not taxable because Fred has sufficient basis to cover the distribution. The $10x of items under Code Sec. 1367(a)(2) are applied to reduce Fred's stock basis to zero, and the excess items reduce his debt basis from $40x to $35x.

Example (5): This example is the same as Example (4) except that the amount of the distribution to Fred is $5x. In this Example (5), there is a net increase because the positive adjustments under Code Sec. 1367(a)(1) exceed the negative adjustments under Code Sec. 1367(a)(2) by $5x. This "net increase" will restore Fred's basis in his debt from $40x to $45x.[15]

> The tax practitioner who is guiding an S corporation client must fully understand these rules and the consequences of their implementation in all situations.

Perhaps more interesting is the analysis with respect to the taxation of the distribution to Fred. Under the rules for the determination of the net increase, the measurement of the net increase takes into account the tax-free distributions under Code Sec. 1367(a)(2). Therefore, the positive adjustments under Code Sec. 1367(a)(1) are first allocated to stock basis to cover the distribution. This approach determines how much of the distribution can be tax free. In this case, $5x of the positive adjustments under Code Sec. 1367(a)(1) are allocated to Fred's stock basis. His stock basis increases from zero to $5x. Under Code Sec. 1368(b)(1), the distribution of $5x to Fred is not subject to tax. Fred's stock basis after the distribution is reduced to zero.

The two examples provide an interesting review of the workings of the net increase rules. In both Example (4) and Example (5), the distribution to Fred is not subject to tax. The determination of net increase is based upon the comparison of the positive adjustments under Code Sec. 1367(a)(1) and the negative adjustments under Code Sec. 1367(a)(2). The negative adjustments include distributions to the shareholder that are not subject to tax under Code Sec. 1368(b). Under Code Sec. 1368(b)(2), because Y Corporation has no C corporation earnings and profits, a distribution to Fred is not subject to tax if the amount of the distribution is less than his adjusted stock basis. Therefore, in each example, some of the positive adjustments are allocated to Fred's stock basis to cover the distribution. In Example (4), after the allocation of the positive adjustments to stock basis, the remainder of the positive adjustments is not greater than the negative adjustments, and therefore there is no net increase. In Example (5), after the allocation of the positive adjustments to stock basis, the remainder of the positive adjustments is greater than the negative adjustments, and therefore there is a net increase. Understanding the inter-relationship between the stock basis rules concerning distributions and the restoration of debt basis rules concerning distributions will help the tax practitioner provide better advice to his or her clients. The Regulations also contain rules for the reduction and restoration of debt basis when the shareholder holds more than one debt. If, at the end of the tax year, the shareholder holds more than one debt, then the rules for the reduction of debt basis are applied to each debt in proportion to the basis of each debt.[16]

Example (6): For the purpose of demonstrating the operation of this rule, assume that Fred has a stock basis of zero, and has made two separate loans to Y Corporation. Fred made a first loan in the amount of $500x and then made a second loan of $1,500x. At the end of the tax year, the negative adjustment of items under Code Secs. 1367(a)(2) (B)–(E) exceeds the positive adjustment of items under Code Sec. 1367(a)(1) by $600x. The reduction of the basis of each debt is done by proportion based upon the basis of each debt. The first debt is reduced by $150x [$600x times $500x (the basis of the first debt) divided by $2,000x (the total basis of all of the debt)] to $350x. The second debt is reduced by $450 [$600x times $1,500x (the basis of the second debt) divided by $2,000 (the total basis of all of the debt)] to $1,050x.[17]

The tax advisor must remember that these multiple debt basis reduction rules apply to any debt

Continued on page 59

S Corporation

Continued from page 30

that the shareholder holds on the last day of the tax year of the S corporation. If the shareholder's equity interest in the S corporation is terminated during the tax year, then the reduction of debt basis rules apply immediately prior to the termination of the equity interest.[18]

If, at the beginning of the tax year, a shareholder has more than one debt, then any net increase applies first to restore the basis of any debt that has been repaid during the tax year and second to restore any other debt in proportion to the amount each such debt has been reduced in prior years under Code Sec. 1367(b)(2)(A). The application of any net increase to any debt that is repaid, either partially or fully, is meant to offset any possible gain from the payment on the debt.[19]

Example (7): For the purpose of demonstrating the operation of this multiple debt basis restoration rule, let's continue with the facts in Example (6). In the next tax year, Fred's stock basis remains at zero. In the prior year, the basis of both of his debts has been reduced. The net increase in this next tax year is $300x. In accordance with the restoration rules, the net increase is applied to restore the debt basis of each debt in proportion to the reduction of the debt basis of each debt in prior years under Code Sec. 1367(b)(2)(A). The total amount of reduction from the prior year was $600x for both of the debts. The first debt is restored by $75x [$300x (the amount of the net increase) times $150x (the amount that the first debt was reduced in prior years) divided by $600x (the aggregate amount of the reduction of all debt in prior years)] to $225x. The second debt is restored by $225x [$300x (the amount of the net increase) times $450 (the amount that the second debt was reduced in prior years) divided by $600x (the aggregate amount of the reduction of all debt in prior years)] to $1,275x.[20]

Example (8): The result in Example (7) is different if the first note were fully repaid by Y Corporation. According to the debt basis restoration rules, if a debt is repaid during the year, then any net increase is first applied to restore the debt basis of such debt so that any gain from the repayment is offset (assuming a sufficient net increase). Y Corporation repaid the first debt in the amount of $500x. Without any net increase, Fred would recognize a gain on the repayment of the loan of $150x, an amount equal to the difference between the payment from Y Corporation ($500x) and the basis of the debt ($350x). However, under the debt basis restoration rules, $150x of the $300x net increase is applied to the first debt and such application is deemed to occur immediately prior to the payment on the debt. Therefore, Fred recognizes no gain on the repayment of the first debt. The remaining net increase ($150x) is applied to restore the second debt to $1,200x.[21]

This Example (8) raises another planning point for the tax practitioner. The debt basis of the first note is restored to $500x by application of a portion of the net increase. In many cases, the applied net increase is an item of ordinary income that Fred must report on his income tax return. If the debt basis were not restored and Fred received a full payment for his note, then the gain from the repayment would (most likely) be capital gain. Therefore, under the application of the debt basis rules, Fred is exchanging a capital gain from the payment on the note for the character of the positive adjustment items applied to him as the restoration of his note.

Example (9): Finally, any net increase in excess of the amount necessary to restore the basis of debt to the original face value of the debt is applied to increase the shareholder's basis in his or her stock.[22] Continuing with Example (8), where Y Corporation in the prior tax year repaid the first debt. In the next tax year, Y Corporation has a net increase of $500x. The net increase is first applied to restore the basis of the second debt to its original face amount of $1,500x. The remaining net increase of $200x is applied to increase Fred's stock basis.[23]

The debt basis rules are complicated. They present many traps, but also many planning opportunities for the tax practitioner. In the audits where I have been involved, I have found that most of the mistakes are made when calculating debt basis. The tax practitioner who is guiding an S corporation client must fully understand these rules and the consequences of their implementation in all situations.

Endnotes

1. Even this portion of the topic can be broad. This article will not attempt to describe the open account debt rules.
2. Code Sec. 1366(d)(1).
3. Code Sec. 1367(b)(2)(A). The tax practitioner must remember that certain distributions reduce stock basis, but distributions have no effect on debt basis.
4. Code Sec. 1367(b)(2)(B).
5. Code Sec. 1367(b)(2)(A); Reg. §1.1367-2(b)(1) and Reg. §1.1367-2(c)(1).
6. Code Sec. 1367(b)(2)(A); Reg. §1.1367-2(b)(1).
7. Reg. §1.1367-2(b)(1).
8. Reg. §1.1367-2(b)(2).
9. Reg. §1.1367-2(c)(1).
10. Reg. §1.1367-2(d)(1).
11. *Id.*
12. Rev. Rul. 64-162, 1964-1 CB 304; Code Sec. 1271(a)(1).
13. Code Secs. 1368(b) and (c).
14. See Reg. §1.1367-2(e), example (4).
15. See Reg. §1.1367-2(e), example (5).
16. Reg. §1.1367-2(b)(3).
17. See Reg. §1.1367-2(e), example (1).
18. Reg. §1.1367-2(b)(2).
19. Reg. §1.1367-2(c)(2).
20. Reg. §1.1367-2(e), example (2).
21. *Id.*
22. Code Sec. 1367(b)(2)(B).
23. Reg. §1.1367-2(e), example (3).

Tax Credit Transactions

Continued from page 42

Tax credits were given more respectful treatment by the Ninth Circuit in *S. Sacks*,[30] where a transaction involving sale-leasebacks of solar energy systems and allocation of solar investment tax credits to the investors was approved over the Commissioner's challenge to the transactions under the economic-substance doctrine. As the Ninth Circuit said:

> If the government treats tax-advantaged transactions as shams unless they make economic sense on a pre-tax basis, then it takes away with the executive hand what it gives with the legislative. A tax advantage such as Congress awarded for alternative energy investments is intended to induce investments which otherwise would not have been made. Congress sought, in the 1977 energy package, of which the solar tax credits were a part, to increase the use of solar energy in U.S. homes and businesses.[31]

The Ninth Circuit says that courts should respect the congressional decision to favor a particular economic activity with tax credits, particularly where the economics of the activity are not, by themselves, sufficient to attract investment capital, thus needing the tax credits to spur their use, be it solar energy and renewable energy or rehabilitation of historic buildings:

> If the Commissioner were permitted to deny tax benefits when the investments would not have been made but for the tax advantages, then only those investments would be made which would have been made without the Congressional decision to favor them. The tax credits were intended to generate investments in alternative energy technologies that would not otherwise be made because of their low profitability. *See* H.R. Rep. No. 496 at 8304. Yet the Commissioner in this case at bar proposes to use the reason Congress created the tax benefits as a ground for denying them. That violates the principle that statutes ought to be construed in light of their purpose. *Cabell v. Markham, 148 F.2d 737 (2d Cir. 1945)* (L. Hand, J.).[32]

There are, therefore, persuasive reasons why the Supreme Court should grant *certiorari* in *HBH* and reverse the decision of the Third Circuit and find that PB was a *bona fide* partner in *HBH* entitled to its 99.9-percent allocation of HRTC in respect of its $18,195,757 capital contribution to HBH.

Endnotes

1. *Historic Boardwalk Hall, LLC*, CA-3, 2012-2 USTC ¶50,538, 694 F3d 425.
2. *Historic Boardwalk Hall, et al., Petitioners*, No. 12-901.
3. Harold R. Berk, Tax Credit Transactions Corner, *Historic Boardwalk Hall*: IRS Appeals to the Third Circuit, J. PASSTHROUGH ENTITIES, Mar.–Apr. 2012, at 59.
4. *Supra* note 1, at 463.
5. *W.O. Culbertson, Sr.*, SCt, 49-1 USTC ¶9323, 337 US 733, 69 SCt 1210.
6. *F.E. Tower*, SCt, 46-1 USTC ¶9189, 327 US 280, 66 SCt 532.
7. *Id.*, at 290.
8. *Supra* note 5, at 740.
9. *Id.*, at 738.
10. *Id.*, at 742 (footnote omitted).
11. *Id.*, at 748.
12. *Supra* note 1, at 463.
13. *TIFD III-E, Inc.*, CA-2, 2006-2 USTC ¶50,442, 459 F3d 220.
14. *Virginia Historic Tax Credit Fund 2001 LP*, CA-4, 2011-1 USTC ¶50,308, 639 F3d 129.
15. *Supra* note 13, at 227.
16. *Id.*, at 228-29.
17. *Id.*, at 240.
18. *Supra* note 1, at 457, n. 56.
19. *Supra* note 5, at 741–42.
20. *Id.*, at 742.
21. *Supra* note 1, at 455.
22. *Id.*, at 454, n. 53.
23. Exhibit 10-J, Docket No, 11273-07 (Tax Court), Amended and Restated Operating Agreement (Appendix filed in Third Circuit under Docket No. 11-1832, page 181).
24. *Supra* note 1, at 456.
25. *Id.*, at 458.
26. *Available at www.ca3.uscourts.gov/oralargument/audio/11-1832Historic%20Boardwalk%20LLC%20v%20Commissioner%20IRS.wma.*
27. *Id.*
28. *Id.*
29. *Supra* note 5, at 749.
30. *S. Sacks*, CA-9, 95-2 USTC ¶50,586, 69 F3d 982.
31. *Id.*, at 992.
32. *Id.*