SHAREHOLDER LOANS MADE SIMPLE

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Shareholders of a corporation taxed under Subchapter S of the Internal Revenue Code may elect a "pass-through" taxation system. Subsequently, a corporation's profits pass through directly to its shareholders on a pro rata basis and are reported on the shareholder's individual tax returns.

The basis of S-Corporation stock is increased by the shareholder's distributive share of corporate income and gains. The basis is increased to reflect the fact that the shareholder is taxed on his share of the corporation's undistributed income. The corporate income, whether or not distributed, is taxed to the shareholders. Conversely, the basis is decreased if this previously taxed income is distributed to the shareholder.

Also, the basis is decreased (but not below zero) by the shareholder's distributive share of corporate deductions and losses. Even though the Internal Revenue Code allows a shareholder to deduct his pro rata share of the corporation's annual losses, a shareholder must have sufficient basis to utilize the entire deduction. A shareholder may not deduct an amount larger than his basis for the stock and any corporate indebtedness owned by him. Otherwise, any unused losses may be carried forward indefinitely. If there are excess corporate losses and deductions from prior years, the shareholder must reduce the basis of the stock to reflect the fact that these amounts have been passed through for use on his individual tax return. Regulations under Section 1367 provide for adjustments to stock basis and debt basis.

Suppose S-Corporation Acme incurs an operating loss of $100,000 in 2006. Also, Craig is the sole shareholder of Acme and Craig's basis in his stock is $20,000. Furthermore, if Craig is a creditor of Acme for the amount of $50,000 then Craig may only deduct $70,000 in 2006. Nevertheless, if during 2006 it appears that Craig's basis will be insufficient to absorb Acme's operating loss then Craig needs to plan accordingly by increasing his basis prior to year-end. Craig has a few options to increase his basis and deduct the loss. Craig could purchase additional shares, contribute to the capital or paid-in surplus of the corporation, or loan money to the corporation.

Under Section 1366, a shareholder's basis increases when a shareholder loans money to the corporation. Furthermore, it is the shareholder's burden to establish his basis under Section 1366. Unlike a partnership, any borrowing conducted by the corporation does not allow a shareholder to increase his basis in stock. The courts have determined that Congress intended to limit a shareholder's loss deduction by the amount the shareholder invested in the corporation.

If Craig decides to loan money to Acme, his investment must meet certain criteria. Thankfully, the courts have had ample opportunities to establish clear guidelines for S-Corporation shareholders like Craig. Practitioners need to look no further than the recent tax court case, Miller v. Commissioner of Internal Revenue, T.C. Memo 2006-125, for guidance when advising clients. For an injection of resources by Craig to be deemed an investment, the investment must be an "actual economic outlay" of money. Furthermore, the actual economic outlay must leave the Craig "poorer in a material sense". The "poorer in a material sense" standard is simply a restatement for the analysis of an ordinary deduction. In other words, as a shareholder, Craig's financial position should not remain the same after the transaction. If a shareholder is only secondarily or contingently liable then shareholder is unable to increase the basis. For example, a shareholder's guarantee of a bank loan to the corporation or a pledge of property as security will be insufficient to increase the shareholder's basis because the shareholder will only be deemed to be secondarily or contingently liable. Even though both a guarantor and lender assume a risk of default, when distinguishing between a guarantor and a lender, the analysis focuses on the lender supplying funds for the borrower. On the other hand, by assuming a risk of default the guarantor only enables the funds to be supplied to the borrower.

In Oren v. Commissioner, T. C. Memo 2002-172, the taxpayer unsuccessfully argued that a direct loan, in itself, is sufficient to increase basis. The court rejected the idea that an economic outlay is required only when there is a shareholder guaranty. The economic outlay doctrine is even applicable to transactions masked as direct loans. If the source of funding is originally from a related party, then a sufficient economic outlay by the shareholder to create basis has not occurred. The courts continue to reason that there is no economic outlay because repayment of the funds is uncertain. The shareholder must be directly liable or must loan his own money to the S-Corporation. In fact, the presence of a third-party lender does not negate basis-generating indebtedness. On the contrary, the third party lender becomes a significant factor in the determination of the loan as a valid economic outlay. An arm's length transaction from an unrelated party provides certainty that the lender will enforce repayment form the shareholder. The funds loaned to a S-Corporation from a "back to back" loan borrowed by the shareholder results in an economic outlay

Another scenario where Craig could create genuine indebtedness is the when there is a note substitution. If Craig becomes an obligor by substituting his own note for the note of his S corporation (whether or not he was initially a guarantor), there is an economic outlay. In a "note substitution" scenario, the S-Corporation's is no longer liable to the third-party lender for the note after the shareholder assumes the debt. Nevertheless, the S-Corporation's indebtedness to the shareholder is deemed a constructive furnishing of funds by the shareholder and thus, an economic outlay.

The presence of appropriate documentation such as notes creating enforceable legal obligations and certified financial statements reflecting a debtor-creditor relationship between the S-Corporation and the shareholder will give substance to the arrangement. Craig should borrow directly from the lender and then loan the funds to the S-Corporation. Furthermore, the lender should record the loan as a loan to Craig. Subsequently, the S-Corporation should record the funds as a loan from Craig, the shareholder. The courts, in particular the Court of Appeals for the Seventh Circuit, apply substance-over-form principles when analyzing a transaction to determine whether an economic outlay took place.

Still yet, even if there is an "actual economic outlay" that increases basis, the funds must be "at risk" within the meaning of Section 465 before a subsequent deduction is deemed proper. As a starting point, section 465(b)(1) states that generally a taxpayer is at risk in an activity to the extent of money contributed or amounts borrowed for use in the activity. Then, 465(b)(2) designates a taxpayer as at risk for the borrowed amounts if there is personal liability for repayment of the loans or if property unrelated to the business has been pledged as security for loan repayment.

However, if there is a loss limiting arrangement, evidenced by non-recourse financing, guarantees or stop loss agreements, a taxpayer will not be considered to be at risk. While the loan must be fully recourse and the obligation to repay must be absolute, the existence of an indemnification clause is often construed as stop loss agreement. Furthermore, the presence of a guarantor will require an inquiry into the extent to which the shareholder is, in any way, protected against loss. Specifically, the Service has specifically stated that, “If the investor is liable for the loan only upon occurrence of a specific event, the taxpayer is effectively protected against the loss if the likelihood of the event is slim".

Still yet, even though a guarantor is able to recover from the primary obligor any amounts that the guarantor is required to pay to satisfy the indebtedness, a waiver by the guarantor of his rights will not necessarily preclude the shareholder from being “at risk”. Agreements and arrangements must be reviewed to detect events that trigger or relieve taxpayers of personal liability. The question is always whether the taxpayer who assumes personal liability is ever required to satisfy the liability, or whether he or she is protected in any way from being required to do so out of his or her own funds. Even though a guarantor is able to recover from the primary obligor any amounts that the guarantor is required to pay to satisfy the indebtedness, a waiver by the guarantor of his rights will not necessarily preclude the shareholder from being “at risk”.

After examining all the facts and circumstances, there must be a realistic possibility that the money invested in the business might actually be lost before the amount will considered at risk. The Court of Appeals for the Seventh Circuit has cited the “realistic possibility of loss” standard with approval but has not expressly adopted it.

Furthermore, if there is other shareholders, Craig would not be able to increase his basis by borrowing money from them to lend the money to the S-Corporation. Any funds borrowed from fellow shareholders are not considered at-risk under Section 465.

To sum up, to properly structure Craig’s loan to his S-Corporation, the transaction must first constitute an economic outlay. The substance of the transaction must leave Craig “poorer in a material sense” to be an economic outlay. Secondly, the loan proceeds must be “at risk” where there is a realistic possibility of loss by the shareholder.