Inadequate Tax Basis: Navigating New IRS Regulations for S Corporations
Leveraging Basis Rules for Guaranteed Loans, Incorporated Pocketbook Theory, and Back-to-Back Loans

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INADEQUATE TAX BASIS: NAVIGATING NEW IRS REGULATIONS FOR S CORPORATIONS

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Background - S Corporation Taxation

- “Pass-through” entity.
- In general, taxed only at shareholder level.
- S corporation reports its taxable income on Form 1120-S.
- Issues K-1s to shareholders who then pick up their share of taxable income or loss and pay taxes on such income.
Background - S Corporation Taxation (cont’d)

- If S corporation generates losses, such losses “pass-through” to the shareholders, who can use them to offset their other income, subject to a number of important limitations.

- Contrast this to C corporation losses, which are “trapped” at the C corporation level and cannot be used to offset shareholder income.

- To make matters worse in the C corporation context, Section 382 effectively prevents the use of C corporation NOLs after ownership changes.

- The ability of S corporation shareholders and LLC members to benefit currently from entity-level losses represents one of the most significant advantages of pass-through entities over C corporations.
Background – Limitations on Use of Losses

- The ability of S corporation shareholders to use S corporation losses is subject to a number of significant limitations:
  - Basis Limitation (Section 1366(d))
  - At-Risk Limitation (Section 465)
  - Passive Loss Limitation (Section 469)

- S corporation losses that pass through to a shareholder can only be used by such shareholder to the extent of the sum of:
  - Adjusted basis of S corporation stock; and
  - Adjusted basis of any “indebtedness of the S corporation to the shareholder.” Section 1366(a)(1)(A) and (B).

- S corporation debt to third parties does not create basis for the S corporation shareholders.
Background – Limitations on Use of Losses (cont’d)

- Contrast this to basis rules in the LLC context, where LLC debt to third parties – whether recourse or non-recourse – does create basis for LLC members.

- Inability of S corporation shareholders to create basis from third-party debt severely limits the ability of S corporation shareholders to efficiently use S corporation losses and thus represents a significant disadvantage of S corporations relative to LLCs.
Background – Limitations on Use of Losses (cont’d)

- Losses that are not currently usable due to a lack of sufficient basis can be carried forward indefinitely until such time that the shareholder has sufficient stock or debt basis.

- Increased basis can generally occur via allocation of S corporation income to the shareholder, or capital contributions or loans from the shareholder to the S corporation.

- Suspended losses, however, are generally personal to the shareholder and thus disappear if the shareholder terminates his S corporation interest by any means, including sale, gift or death.
Case Law

- Section 1366(d)(1)(B) does not specifically define what constitutes “indebtedness of the S corporation to the shareholder.”

- Case law and IRS rulings interpreting Section 1366(d)(1)(B) established two requirements:
  - The indebtedness must run directly from the S corporation to the shareholder; and
  - The shareholder must have an “actual economic outlay” that causes the taxpayer be to “poorer in a material sense.”

Case Law (cont’d)

- It is well settled under the case law that a shareholder’s guarantee of a corporate debt alone does not create an indebtedness of the corporation to the shareholder. See e.g., Raynor v. Comm’r, 50 T.C. 762 (1968); see also Leavitt v. Comm’r, 90 T.C. 206 (1988) aff’d, 875 F.2d 470 (4th Cir. 1989), cert. denied, 493 U.S. 958 (1989). But see Selfe v. U.S., 778 F.2d 769 (11th Cir. 1985).

- If the shareholder made a payment on the guarantee, however, a direct indebtedness of the corporation to the shareholder is created, and basis is increased. Rev. Rul. 70-50, 1970-1 C.B. 178.
Similar to a guarantee, a loan from an entity owned by the shareholder to the corporation generally will not increase basis because it is not directly between the S corporation and the shareholder as is required.

This requirement led taxpayers to structure, restructure, or characterize transactions as back-to-back loans in an effort to create sufficient basis to take losses.

These transactions led to a significant body of case law and IRS rulings, often with decisions reaching contradictory results based on very similar facts.
Case Law (cont’d)

- Back-to-back loans between unrelated parties.
  - For example, bank loans shareholder money, shareholder loans money to its wholly owned S corporation.
  - Case law typically allows the shareholder basis for back-to-back loans with a third-party lender. See e.g., Miller, supra.

- Back-to-back loans between related parties.
  - For example, shareholder is sole owner of S corporation 1 and S corporation 2. In order to use losses generated by S corporation 2, S corporation 1 loans funds to shareholder, who then loans funds to S corporation 2.
  - IRS has typically sought to disallow basis for back-to-back loans when the source of funds was a related-party lender. See e.g., Oren, supra; see also Underwood v. Comm’r, 535 F.2d 309 (5th Cir. 1976), affg. 63 T.C. 468 (1975).
Back-to-back loans between related parties (cont’d)

- Courts, however, have explicitly rejected the idea that a shareholder could not obtain basis from a related party back-to-back loan. See e.g., Ruckriegel v. Comm’r, T.C. Memo. 2006-78; see also Yates v. Comm’r, T.C. Memo. 2001-280 and Culnen v. Comm’r, T.C. Memo. 2000-139.

- Nevertheless, the IRS has been successful on numerous occasions in situations involving related party back-to-back loans. See e.g., Oren, supra.

- As such, the law was uncertain with respect to whether a shareholder would obtain basis in many back-to-back loan situations.
New Regulations - Procedural History

- On June 11, 2012, the IRS issued Proposed Regulations addressing shareholder guarantees and back-to-back loans.
- The Proposed Regulations were finalized on July 22, 2014, with no substantive changes.
- These Final Regulations have a partial retroactive effective date – taxpayers can rely on the back-to-back loan concepts of the Final Regulations “with respect to indebtedness between an S corporation and its shareholder that resulted from any transaction that occurred in a year for which the period of limitations on the assessment of tax has not expired before July 23, 2104.”
New Regulations - Guarantees

- The Final Regulations retain the “actual economic outlay” standard in the case of shareholder guarantees of S corporation debt.

- Thus, a shareholder guarantee of S corporation debt will not create or increase the shareholder’s basis until there has been an “actual economic outlay” by the shareholder (i.e., the shareholder is required to make a payment pursuant to the guarantee).

- A payment by an entity disregarded for federal income tax purposes (e.g., a single-member LLC owned by a shareholder) in which a shareholder is the sole owner is considered a payment by the shareholder.
New Regulations - Back-to-Back Loans

- Effectively eliminate the “actual economic outlay” and “poorer in a material sense” standards.
- Instead, Final Regulations provide that for debt to be included in basis, the debt must be “bona fide indebtedness of the S corporation that runs directly to the shareholder. Whether indebtedness is bona fide indebtedness to the shareholder is determined under general Federal tax principles and depends on all of the facts and circumstances.”
What is bona fide debt?

Preamble to the Proposed Regulations cited to the following cases four cases:

- *Knetsch v. U.S.*, 364 U.S. 361 (1960);
- *Geftman v. Comm’r*, 154 F.3d 61 (3d Cir. 1998);
- *Estate of Mixon v. U.S.*, 464 F.2d 394, 402 (5th Cir. 1972);

This analysis will be highly fact specific and debt/equity determinations frequently lend themselves to litigation between the taxpayer and the IRS.
New Regulations – Back-to-Back Loans (cont’d)

Debt/Equity Factors in *Estate of Mixon*.

- The names given to the certificates evidencing the indebtedness.
- The presence or absence of a fixed maturity date.
- The source of principal payments.
- The right to enforce payment of the principal and interest.
- Participation in management as a result of the transaction.
- The status of the loan in relation to regular corporate creditors.
- The intent of the parties.
- "Thin" or adequate capitalization.
New Regulations – Back-to-Back Loans (cont’d)

Debt/Equity Factors in *Estate of Mixon* (cont’d).

- Identity of interest between creditor and stockholder.
- Source of interest payments.
- The ability of the corporation to obtain loans from outside lenders.
- The extent to which the loan was used to acquire capital assets.
- The failure of the debtor to repay on the due date or to seek a postponement.

- Query whether this new standard in effect only simplifies the formulation of the test, not its actual application.
New Regulations – Back-to-Back Loans (cont’d)

- Final Regulations provide two examples of back-to-back loans – one involving a direct back-to-back loan and one involving a restructuring of a loan arrangement.

- A commentator requested that the Final Regulations provide an example addressing situations where there are circular cash flows.
  
  - For example, a loan originally made by an S corporation (S1) owned by a shareholder to another S corporation (S2) owned by that shareholder is restructured by either (i) S1 lending money to the shareholder, the shareholder lending the money to S2, and S2 using the money to repay S1 or (ii) S2 repaying S1, S1 lending the money to the shareholder, and the shareholder lending the money back to S2.
New Regulations – Back-to-Back Loans (cont’d)

- IRS rejected the request to add a circular cash flow example, and stated in the Preamble that it was aware of cases where a circular flow of funds did not create bona fide indebtedness. *Oren, supra; Kerzner v. Comm’r*, T.C. Memo. 2009-76.

- Should practitioners be concerned with this refusal to include a circular cash flow example?
New Regulations - Incorporated Pocketbook Theory

- Under this theory, an S corporation shareholder claims that a transfer from a related entity directly to the shareholder’s S corporation was made on the shareholder’s behalf and is, in substance, a loan from the related entity to the shareholder, followed by a loan from the shareholder to the S corporation.

- Several cases support this theory. See e.g., Culnen and Yates, supra.

- Final Regulations do not directly address this situation, but presumably this could work if facts established a bona fide creditor-debtor relationship directly between shareholder and borrowing S corporation.
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New Regulations - Examples

Example 1 -- Shareholder Loan Transaction
- A, the sole shareholder of S, an S corporation, makes a bona fide loan (determined under general Federal tax principles) to S.
- A’s loan to S increases A’s basis of indebtedness.
- The result is the same if A made the loan to S through an entity that is disregarded as an entity separate from A.
Example 2 -- Back-to-Back Loan Transaction

- A is the sole shareholder of two S corporations, S1 and S2.
- S1 loaned $200,000 to A, who then makes a bona fide loan (determined under general Federal tax principles) of $200,000 to S2.
- A’s back-to-back loan increases A’s basis of indebtedness in S2.
- The result is the same if A made the loan to S2 through an entity that is disregarded as an entity separate from A.
Example 3  --  Loan Restructuring Through Distributions.

- A is the sole shareholder of two S corporations, S1 and S2.
- In May 2014, S1 made a loan to S2, and in December 2014, S1 assigned its creditor position in the note to A by making a distribution to A of the note.
- Under local law, after S1 distributed the note to A, S2 was relieved of its liability to S1 and was directly liable to A.
- Whether S2 is indebted to A rather than S1 is determined under general Federal tax principles and depends upon all of the facts and circumstances.
- If the note constitutes bona fide indebtedness from S2 to A, the note increases A’s basis of indebtedness in S2.
Example 4 -- Guarantee

- A is a shareholder of S, an S corporation.
- In 2014, S received a loan from Bank, and Bank required A’s guarantee as a condition of making the loan to S.
- Beginning in 2015, S could no longer make payments on the loan and A made payments directly to Bank from A’s personal funds until the loan obligation was satisfied.
- For each payment A made on the note (but not before that), A obtains basis of indebtedness.
- Thus, A’s basis of indebtedness is increased during 2015 to the extent of A’s payments to Bank pursuant to A’s guarantee.
Practical Tips for Structuring Back-to-Back Loans

- If at all possible, the back-to-back loan should be with an unrelated third party, e.g., a bank.
- Each loan (i.e., “outside lender to shareholder loan,” and “shareholder to S corporation loan”) should be properly (and separately) documented and enforceable under local law.
- Ideally, security for the “outside lender to shareholder loan” should come from the shareholder’s personal assets. If this is not feasible and S corporation assets need to be pledged, the S corporation should pledge its assets to the shareholder on the “shareholder to S corporation loan,” and the shareholder can then assign this pledge to the outside lender to secure the “outside lender to shareholder loan.”
Practical Tips for Structuring Back-to-Back Loans (cont’d)

- If at all possible, there should be some variation between the terms of the two loans (e.g., different interest rates and/or repayment schedules).
- Ideally, the S corporation should not make loan payments directly to the lender on behalf of the shareholder. Rather, the S corporation should make payments on its loan to the shareholder, and the shareholder should separately make payments to the lender.
- The S corporation’s books and records should be consistent with the separateness of the two loans, and all journal entries should reflect the existence of two separate loans.