Back-to-Back Loans, S Corporations and Basis

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Few tax aficionados do not know that S corporations are fundamentally unlike partnerships in their treatment of basis. The rules are not all that complicated, but they need to be observed. Perhaps of greatest moment is the nonintuitive rule that you can't claim losses from an S corporation unless you have sufficient basis.

Yet basis here comes in two forms, stock basis and debt basis. Both count. It is therefore quite common for tax lawyers and accountants, and for clients themselves, to wake up near the end of a tax year and realize that there's a big loss coming down the pike for the year, but one or more shareholders of the S corporation just won't have sufficient basis to claim it. What to do?

Traditionally, the answer has been to loan money to the S corporation. After all, a shareholder loan to the corporation will increase the shareholder's basis in his S corporation stock. There can be difficulties with this, as where the shareholder loans the money to the corporation on December 25, and the corporation repays the money on January 5. Should the loan be respected?

Most people will probably argue that it should, assuming that you can make the case that the loan was really debt for tax purposes when it was made. Yet there may well be disagreement, particularly where the loan is outstanding a short time. It is even worse where the corporation and shareholder do this every year.

Then there is the back-to-back loan issue. Most practitioners, seasoned and unseasoned alike, know that you generally don't want an S corporation to itself incur debt. Instead, you want the shareholder(s) to incur it and then to loan the proceeds to the corporation. Why?

Because if the corporation is the obligor to the outside lender, that loan doesn't create debt basis to the shareholders. Conversely, if the shareholders borrow the money, and in turn loan it to the S corporation, they are credited with debt basis. Along with their basis in their S corporation stock, their basis in their debt loaned to the S corporation will be available as a repository against which they can deduct losses from the S corporation.

AICPA Plan

One can't deny that this is formalistic. Of course, formalism and tax law seem to go together like bread and butter. Nevertheless, many an old-time practitioner out there (like me) may well wonder if there's a way to clean up this area.

That's what the AICPA has recently proposed in comments to the Treasury on Guidance Under Section 1367 Regarding S Corporations and Back-to-Back Loans. What have they proposed? Well, the nuggets of their proposal are here.

A shareholder note would be treated as debt qualified to permit the S corporation shareholder to increase his basis in indebtedness from the corporation (and assuming the taxpayer meets the at-risk and passive activity loss limitations) to deduct losses under Code Sec. 1366(d) only if it has all of the following characteristics:

1. The note is a written unconditional promise by the corporation to pay the shareholder, on demand or on a specified date, a sum certain in money.
2. The interest rate specified in the instrument meets, at a minimum, the applicable federal rate for the type of loan and for the period the loan is made.
3. Interest payment dates are specified in the instrument.

4. The instrument is legally enforceable under state law.
5. The S corporation is not an obligor or co-obligor on the note issued by the shareholder to the primary lender in a back-to-back situation. A guarantee or pledge of corporate assets is not to be considered as making the company an obligor.
6. Interest and principal payments are made pursuant to the agreement, *i.e.,* the company pays the shareholder, and the shareholder pays the primary lender (if mistakes are made and direct payment is made, the books and records are adjusted and appropriate information reporting forms are filed).
7. Loans are reported appropriately on tax returns and year-end financial statements, if any, of the company and shareholder.

These criteria are more extensive than those of the straight debt safe harbor of Code Sec. 1361(c)(5)(B), which are intended solely to ensure that debt does not create a second class of S corporation stock. Given that the sole purpose of this new debt safe harbor is to ensure that a shareholder receives an increase in his debt basis, the AICPA admits it doesn't cover all situations. Factual situations outside the safe harbor would be judged on all the facts and circumstances.

Here are a few examples from the AICPA of what they have in mind:

> **Example 1—**Back-to-Back Loans Involving Unrelated Third Party Lenders. Bank lends $100,000 to Individual A at commercially reasonable rates and terms (the "X Bank Loan"). Individual A immediately lends the funds to Corporation L, an S corporation, in the form of debt for use as working capital. The terms of the loan from A to L are also commercially reasonable. The payments of the X Bank Loan to A are made by A according to the terms. If the shareholder debt otherwise meets all requirements of the safe harbor, Individual A would have an increase in adjusted basis in debt of $100,000 under section 1366(d)(1).

> **Example 2—**Substituted or Subrogated Debt. A, an S corporation, is owned by shareholders B and C. A has borrowed $500,000 from Bank. Subsequently, shareholders B and C substitute personal notes with the bank for A's corporate note with the bank such that the corporation now owes B and C $500,000, and B and C owe the bank. The bank fully extinguishes the indebtedness of the corporation to the bank. If the shareholder debt otherwise meets all requirements of the safe harbor, the new shareholder loans should give rise to combined B and C debt basis of $500,000.

Conclusion

It is too soon to say what will become of the AICPA's comments. They seem to make sense, and they recognize that these issues have been litigated over and over again. Still, one part of the issue has more to do with taxpayer sloppiness than with anything else.

Indeed, it remains surprising just how ignorant some people are of these rules. More than a few tax practitioners have been forced to play Monday morning quarterback, looking at debt that is badly designed and implemented, where the goal is to insure that S corporation shareholders have sufficient basis to use losses. Often, practitioners are thrust into this role when it is arguably too late to do much about it.

Whatever happens to the AICPA's plea for clarity here, we need more focus on the basics *before* these problems arise.