



Agricultural Law Press

Publisher/Editor

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Agricultural Law Digest

Volume 30, No. 11

May 24, 2019

ISSN 1051-2780

When Does An S Corporation Loan Increase a Shareholder's Stock Basis

-by Robert P. Achenbach, Jr., J.D.

Because of the pass-through nature of S corporation tax items,¹ a shareholder's basis in the stock of the corporation is important where the shareholder wishes to take immediate advantage of corporate net operating losses.²

Initial Stock Basis

An S corporation shareholder's basis in stock issued upon the shareholder's joining the corporation is determined under the rules for C corporations.³ Thus, in general an S corporation shareholder's initial stock basis equals the value of property contributed to the corporation less any boot received in the exchange.⁴

Changes to a Shareholder's Stock Basis

The basis of an S corporation shareholder's stock is increased, on a per share-per day basis, by the shareholder's *pro rata* share of:

- (1) the corporation's separately stated items of income;
- (2) the corporation's items of income not separately stated; and
- (3) the excess of the corporation's deductions for depletion over the basis of the property subject to depletion.⁵

Similarly, the basis of an S corporation shareholder's stock is decreased, on a per share-per day basis, (but not below zero) by:

- (1) distributions that are not includable in the shareholder's income under I.R.C. § 1368;
- (2) the shareholder's pro rata share of corporation items of loss and any expense of the corporation that is not deductible in computing its taxable income and not chargeable to a capital account;⁶ and
- (3) deductions for depletion to the extent that the deduction does not exceed the basis of the property subject to depletion.⁷

Claiming Pass-Through Losses and Deductions

In general, the amount of pass-through losses and deductions taken into account by a shareholder for any taxable year may not exceed the sum of the shareholder's adjusted

* Publisher and editor of the Agricultural Law Press.

basis in the stock of the S corporation and in any indebtedness of the S corporation to the shareholder.⁸ If a shareholder's aggregate *pro rata* share of the pass-through items of loss and deduction exceeds the sum of the shareholder's adjusted bases in stock and debt, the limitation on losses and deductions must be allocated among the shareholder's *pro rata* share of each loss or deduction.⁹

Any loss or deduction for the taxable year not taken into account by a shareholder by reason of the basis limitation rule is treated as incurred by the S corporation with respect to that shareholder in the corporation's first succeeding taxable year and subsequent taxable years.¹⁰ The shareholder's disallowed pass-through losses can be carried forward indefinitely to tax years in which the shareholder has basis in the stock.¹¹

Thus, if a shareholder desires to take advantage of corporate losses in a given tax year and the shareholder has little or no basis in the stock (perhaps from past corporate loss pass-through), the shareholder has a few options to take to increase the basis, such as purchasing more stock in the corporation or lending money to the corporation.

Increasing A Shareholder's Stock Basis by Loans to the S Corporation

S corporation shareholders may increase their basis of indebtedness of the S corporation to the shareholder only if the indebtedness is *bona fide* and runs directly to the shareholder.¹² This is the major issue in a substantial number of cases,¹³ where a shareholder has attempted to increase the stock basis but failed to prove a *bona fide* loan for which the shareholder is liable in all cases.

Shareholder Guarantee of S Corporation Debt. Corporate debts to third parties that have been guaranteed by a shareholder of an S corporation generally are not considered to be loans which can increase a shareholder's stock basis¹⁴ unless it can be proved that the third party lender looks to the shareholder as the primary obligor on the corporate debt and the corporation is thinly capitalized.¹⁵

Loans from Related Entities. If a shareholder engages in genuine "back-to-back" loans in which an affiliated entity loans the shareholder funds that are in turn loaned directly to the S corporation, those loans can establish *bona fide* indebtedness running directly to the shareholder.¹⁶

Similarly, two cases have allowed an increase in basis where the shareholder uses a separate wholly-owned entity as a "incorporated pocketbook" habitually to pay the obligations of the S corporation.¹⁷

Meruelo v. Commissioner¹⁸

In this recent case, the taxpayer owned partial interests in several pass-through entities (the affiliates) and sought to deduct net operating losses from an S corporation (the S corporation) in one tax year using a stock basis created by a personal loan to the S corporation and amounts owed to the S corporation by the affiliates. The S corporation needed \$10 million to secured a leveraged purchase of real property. The taxpayer personally borrowed \$4,985,035 and loaned the funds to the corporation for this purpose. The IRS and taxpayer agreed that this loan and contribution increased the taxpayer's basis in the S corporation

by \$4,985,035.

The S corporation entered into hundreds of transactions with the affiliates in which the taxpayer owned an interest. Each tax year, the net amount owed by the S corporation to the affiliated entities was allocated to the taxpayer based on the taxpayer's interest in the affiliates. The taxpayer treated these amounts as loans to the S corporation, and the taxpayer claimed that these "loans" increased the basis of the taxpayer's S corporation stock.

The S corporation had a \$26 million loss when the S corporation's creditors foreclosed on the real property. The corporation allocated \$13 million of the loss to the taxpayer, based on the taxpayer's 49 percent share of the S corporation. The taxpayer claimed a loss deduction for the \$13 million based on the increase in the taxpayer's basis from the \$4,985,035 loan contribution and \$8,051,826 allocated from the amounts the S corporation owed to the affiliates. The IRS audited the taxpayer's return and allowed only the \$4,985,035 to increase the taxpayer's basis and as the limit of the loss deduction.

The taxpayer asserted both the "back-to-back" loan and "incorporated pocketbook" theories to support including the \$8,051,826 as an increase in stock basis.

The court found that no actual outlay of funds was made by the affiliates to the taxpayer; therefore, the "back-to-back" loan theory did not apply in this case. The court noted that the S corporation and affiliates did not treat the net amounts each year as loans but as accounts payable. The court rejected the taxpayer's attempt to recharacterize these amounts as loans.

The court also found that the "incorporated pocketbook" theory did not apply because (1) the affiliates were not wholly-owned or even controlled by the taxpayer and (2) there was no established practice of the affiliates paying the obligations of the S corporation for the taxpayer. In addition, under both theories, the taxpayer failed to prove that any of the obligations ran directly to the taxpayer or that the taxpayer suffered any economic outlay to the S corporation.

In conclusion

Because unexpected losses, such as in this case a foreclosure, can occur, S corporation shareholders and members of any pass-through entity need to document and calculate their basis in their interest in the entity at least annually to support the pass-through and deductibility of such losses, keeping in mind the requirements of the S corporation basis regulations.

ENDNOTES

¹ See Harl and Achenbach, *Agricultural Law*, § 56.02 (2019).

² See Harl and Achenbach, *Agricultural Law*, § 56.02[6], [7] (2019).

³ See Harl and Achenbach, *Agricultural Law*, § 53.03 (2019).

⁴ I.R.C. § 358(a); see Treas. Reg. § 1.358-1(a). Boot includes any indebtedness to which the transferred property is subject or which is assumed by the corporation.

⁵ Treas. Reg. § 1.1367-1(b). Note that the increases are based on the corporation's income items and is not dependent upon whether any actual distributions of income to the shareholder

occur.

⁶ See *Barnes v. Comm'r*, T.C. Memo. 2012-80, *aff'd*, 712 F.3d 581 (D.C. Cir. 2013) (S corporation shareholders' basis in their interests decreased by their share of losses whether or not claimed as deduction on shareholders' individual returns).

⁷ Treas. Reg. § 1.1367-1(c).

⁸ I.R.C. § 1366(d)(1); Treas. Reg. § 1.1366-2(a).

⁹ Treas. Reg. § 1.1366-2(a).

¹⁰ I.R.C. § 1366(d)(2); Treas. Reg. § 1.1366-2(a).

¹¹ I.R.C. § 1368(e)(3).

¹² Treas. Reg. § 1.1366-2(a)(ii)(2): "(2) Basis of indebtedness-(i) In general. The term basis of any indebtedness of the S corporation to the shareholder means the shareholder's adjusted basis ... in any bona fide indebtedness of the S corporation that runs directly to the shareholder. Whether indebtedness is bona fide indebtedness to a shareholder is determined under general Federal tax principles and depends upon all of the facts and circumstances."

¹³ See Harl and Achenbach, *Agricultural Law*, § 56.03[3] (2019).

¹⁴ See *Perry v. Comm'r*, 47 T.C. 159 (1966), *aff'd* 392 F.2d 458, 459-461 (8th Cir. 1968); *Goatcher v. United States*, 944 F.2d 747 (10th Cir. 1991) (shareholder guarantee of corporate loan from bank not considered capital contribution and did not increase

shareholder's basis in stock); *Uri v. Comm'r*, 949 F.2d 371 (10th Cir. 1991), *aff'g* T.C. Memo. 1989-58 (same); *Catalano v. Comm'r*, 240 F.3d 842 (7th Cir. 2001), *aff'g* T.C. Memo. 1998-447 (same); *Estate of Bean v. Comm'r*, 2001-2 U.S. Tax Cas. (CCH) ¶ 50,669 (8th Cir. 2001), *aff'g* T.C. Memo. 2000-355 (same).

¹⁵ See *Hargis v. Koskinen*, 2018-1 U.S. Tax Cas. (CCH) ¶ 50,295 (8th Cir. 2018), *aff'g* T.C. Memo. 2016-232 (loans guaranteed by shareholders did not increase basis; no evidence that lender would look to shareholders for payment); *Tinsley v. Comm'r*, T.C. Summary Op. 2017-9 (same); *Phillips v. Comm'r*, 2018-1 U.S. Tax Cas. (CCH) ¶ 50,253 (11th Cir. 2018), *aff'g* T.C. Memo. 2017-61 (shareholder guarantee of S corporation loans did not increase basis, even where shareholder eventually had to pay after corporation's default on loans); *Estate of Leavitt v. Comm'r*, 90 T.C. 206 (1988), *aff'd*, 875 F.2d 420 (4th Cir. 1989), *cert. denied*, 493 U.S. 958 (1989) (shareholders could not increase basis of stock from guarantee of S corporation loan from third party where shareholders were never called upon to repay loan).

¹⁶ Treas. Reg. § 1.1366-2(a)(2)(iii)(Example 2).

¹⁷ *Yates v. Comm'r*, T.C. Memo. 2001-280; *Culnen v. Comm'r*, T.C. Memo. 2000-139, *rev'd on other grounds*, 89 AFTR 2d 2002-383 (3d Cir. 2002).

¹⁸ 2019 U.S. App. LEXIS 13505 (11th Cir. 2019).

CASES, REGULATIONS AND STATUTES

BANKRUPTCY

CHAPTER 12

PLAN. The debtors, husband and wife, filed for Chapter 12 and listed a secured claim of a bank in most of their farm assets and a partially secured claim of a creditor which had a priority lien on their pickup and the proceeds of their 2017 crop. The creditor had obtained a subordination agreement with the bank to allow the priority on the 2017 crop proceeds. The 2017 crop was sold and a portion of the proceeds was used to pay creditors and the debtors sought permission to use the remaining proceeds to start a cattle deeding operation. The debtors filed a plan which proposed to use the profits from the cattle operation and rental payments from renting grain bins to make interest payments on their debts for five years, with a balloon payment at that time. The creditors objected to the plan arguing that the debtors failed to satisfy three of the six requirements of Section 1225: (1) treatment of collateral under Section 1225(a)(5), (2) feasibility under Section 1225(a)(6), and (3) good faith under Section 1225(a)(3). Requirement (1): Under Section 1225(a)(5), the debtor must provide that the creditor retain its lien in the original collateral. The court found that the debtors' plan changed the creditor's lien in the crop proceeds to a lien on the cattle and feed purchased with the proceeds and removed the bank's lien on the rent from the grain bins. The court held that Section 1225(a)(5)(B)(i) prevented the substitution of new collateral in an existing lien and the removal of the bank's

lien as to the grain bin rentals; therefore, the plan could not be confirmed under Section 1225(a)(5). Requirement (2): The court found that the debtors failed to provide sufficient evidence that the cattle operation and grain bin rentals would produce sufficient income to make the plan interest payments and the final balloon payment; therefore the plan was not confirmable under Section 1225(a)(6). Requirement (3): the court found no evidence of bad faith by the debtors but held that, on the basis of the other two requirements, the plan could not be confirmed. ***In re Fuelling*, 2019 Bankr. LEXIS 1379 (Bankr. N.D. Iowa 2019).**

FEDERAL ESTATE AND GIFT TAXATION

No items.

FEDERAL FARM PROGRAMS

APPLES. The AMS has issued proposed regulations which revise the U.S. Standards for Grades of Apples by removing smooth net-like russeting as a grade-determining factor in the U.S. Extra Fancy, U.S. Fancy, and U.S. No. 1 grades for Fuji apples. **84 Fed. Reg. 19743 (May 6, 2019).**