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# S Corporation Shareholder Stock Basis & Bona Fide Shareholder Debt



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# Shareholder Debt Basis

- IRC §1366(d)(1)(B) states that losses are allowed up to the amount of the shareholder's adjusted basis of any indebtedness of the S corp to the shareholder.
- S corp shareholder does not get basis in the debts of the entity.



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# What Qualifies as Indebtedness of the S Corp to the Shareholder?

- Treas. Reg. § 1.1366-2(a)(2)(i)
  - Provides that shareholders obtain basis in indebtedness if the S corp owes a bona fide debt directly to the shareholder.
  - Finalized and effective on July 23, 2014.





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# Case Law Factors

1. a written instrument,
2. a stated interest rate,
3. a maturity date,
4. an enforceable debt under state law,
5. a reasonable expectation of repayment,
6. creditor remedies upon default; and
7. repayment or other conduct that indicates the parties upheld the terms of the debt.

For additional factors see Notice 94-47.



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# Entity Level Debt

- The shareholder does not get basis in entity-level debt.
- There is no bona fide debt between the shareholder and the corp.



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# Loan Guarantees

- Acting as a guarantor or as a surety, accommodation party, or in any similar capacity does not give rise to basis in indebtedness.
- Treas. Reg. §1.1366-2(a)(2)(ii)



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# Payment on Loan Guarantee

- When a shareholder makes a payment on bona fide indebtedness of the S corp for which the shareholder has acted as guarantor or in a similar capacity, then the shareholder may increase the shareholder's basis of indebtedness to the extent of that payment.
- Treas. Reg. §1.1366-2(a)(2)(ii)



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# Judgment on Default Loan Guarantee

- Judgment was imposed on the shareholder as a result of his loan guarantee.
- Shareholder did not make any payments.
- Shareholder did not become the primary obligor.
- No debt between the shareholder and the corp.
- *Montgomery v. Comm.*, T.C. Memo 2013-151.





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# Co-Maker or Co-Borrower

- Shareholder owes the bank.
- Corporation owes the bank.
- No bona fide debt between the shareholder and the corporation.
- *Salem v. Comm.*, TC Memo 1998-63 aff'd, 196 F.3d 1260 (11th Cir. 1999)



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# Back to Back Loans

- A back-to-back loan is when a person borrows money from one party and lends that money to another.
- In the case of an S corp, the shareholder usually borrows money and then lends it to an S corp.



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# Bank Loan to Shareholder followed by Loan to S Corp

- The shareholder is personally liable for the debt and there is bona fide indebtedness from the S corp to the shareholder.
- *Gilday v. Comm.*, T.C. Memo 1982-242





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# Related Entity Loans Money to S Corporation

- Corp owned 100% by shareholder loans money to the S corporation which shareholder also owns 100%.
- S Corp does not owe the shareholder anything (there is no bona fide debt between S Corp and shareholder).
- Rev. Rul. 69-125.



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# Loan from Related Party to Shareholder then Loaned to S Corp

- Based on the facts and circumstances, one must determine if there is bona fide debt from S Corp owed to the shareholder.
- Treas. Reg. §1.1366-2(a)(2)(iii), Example 2.



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# Distribution from Related Party to Shareholder then Loan to S Corp

- Distribution made from Related Entity followed by contribution by shareholder to S Corp.
- If a distribution occurred, the shareholder's basis in the related entity has decreased and his basis in S Corp has increased.
- *Maguire v. Comm.*, T.C. Memo. 2012-160

# Circular Flow of Funds

- Generally funds start with one entity, are lent or distributed to other persons and/or entities, and end up with the original entity.
  - May provide the shareholder with debt basis.
  - When the transaction lacks substance or the shareholder is merely a conduit, the shareholder is not allowed debt basis.

Examples: *Oren v. Comm.*, 357 F.3d 854 (8th Cir. 2004) and *Kaplan v Comm.*, T.C. Memo 2005-218.





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# Additional Information

- [www.irs.gov](http://www.irs.gov) – Key word: S Corporation
- Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc. and Instructions to Schedule K-1 (1120S).
- Form 1120S, U.S Income Tax Return for an S Corporation







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