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Gain Clarified in Shareholder Loans to S Corporations

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It is common for shareholders of an S corporation to lend funds to the corporation, frequently without formal loan documents. It is also common for questions to arise as whether, and in what manner, these loans and their repayment affect the pass-through of corporate items of loss and deduction to the S corporation shareholders, or (as to repayment) require the recognition of gain by shareholders.

In *Brooks v. Commissioner* (TC Memo 2005-204, Aug. 25, 2005), the Tax Court, in a memorandum decision, concluded that shareholders did not have to recognize gain upon the repayment of advances in 1999 or 2000, notwithstanding that the shareholders' tax basis in these loans had been reduced to zero before the payments were made. In order to place this conclusion in context, a review of some fundamental rules regarding S corporation taxation, and of certain tax consequences of shareholder loans to S corporations in particular, may be helpful.

Background

Because corporations that elect to be taxed as S corporations for federal tax purposes are pass-through entities, items of income, loss, deduction, and credit generally pass through to their shareholders annually under IRC §1366, whether or not distributions of cash or property are made. Under IRC §1366(d), however, S corporation losses and deductions are not taken into account by a shareholder to the extent the shareholder's portion of the aggregate of the losses and deductions of the corporation exceeds the sum of (i) the shareholder's adjusted basis in stock of the S corporation and (ii) the adjusted basis of the shareholder in any indebtedness of the S corporation to the shareholder.

The basis of each shareholder's stock is adjusted annually, pursuant to IRC §1367, to increase the basis of the shareholder's stock by the shareholder's share of corporate income and capital contributions and to reduce such basis by the shareholder's share of corporate losses and distributions, thereby avoiding the creation of duplicative or artificial gains or losses when cash or property is distributed or when the stock is sold. Basis reductions are applied to stock, until the shareholder's basis in the stock is reduced to zero.

If the amount of the reduction in basis under these rules that is attributable to items of loss and deduction, and that would otherwise apply to a shareholder's stock in the corporation, exceeds the shareholder's basis in such stock, the excess is applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the corporation to the shareholder.

It is clear that if a shareholder loan to an S corporation is repaid after the basis of the loan has been reduced, the shareholder will, in general, be required to recognize income determined by reference to the excess of the amount paid over the remaining basis (if any) of the debt. If the shareholder receiving such a payment with respect to a reduced-basis loan makes a further advance to the corporation later in the same year, however, neither the provisions of the Code nor the regulations thereunder make clear whether the repayment and advance over the course of the year may be netted in determining whether and to what extent the shareholder is required to recognize gain by reason of the repayment. That issue was the focus of the *Brooks* case.

'Brooks'

In *Brooks*, the stock of an S corporation was owned by two individuals, Fleming G. Brooks and Fleming S. Brooks, in a 49%/51% ratio. At all relevant times each shareholder had a zero basis in his shares.

In 1997, each shareholder advanced $500,000 to the corporation "on open account." During 1997 and 1998, the corporation incurred losses that reduced the basis in the open account debt to zero.

On January 5, 1999, each shareholder's advance of $500,000 was repaid in full. On the last day of the same calendar year, each shareholder advanced $800,000 to the corporation on open account.

On January 3, 2000, the advances made a few days earlier were repaid in full. In December of the same year, each shareholder advanced $1,100,000 to the corporation on open account.

The shareholders asserted, and the government did not dispute that the advances aggregating $1,600,000 at the end of 1999 and $2,200,000 at the end of 2000 had the effect of increasing shareholder bases for purposes of the rule in IRC §1366(d) limiting the pass-through of losses, and provided the shareholders with sufficient basis in each year to permit the pass-through to each shareholder of his share of the corporation's losses for the year.

The government contended, however, that that each shareholder, as a lender, was required to recognize income in the years at issue (1999 and 2000) to the extent that the amount repaid exceeded the shareholder's basis in corporate debt at the time of the repayment, without regard to the advance made later in the same year by the same shareholder.

The Tax Court had previously held, in a decision affirmed by the Court of Appeals for the Fifth Circuit, that income was required to be recognized by shareholders of an S corporation in a farming business that advanced funds to the corporation each fall and repaid those funds shortly after year-end (*Cornelius v. Commissioner*, 58 T.C. 417 (1972), affirmed, 74-1 USTC ¶9446 (5th Cir. 1974)).

In Cornelius, corporate losses reduced the bases of the shareholders' stock to zero and thereafter reduced the bases of shareholder loans to the corporation. Although the loans were not documented with notes, each shareholder loan and the repayment thereof was determined to constitute a separate, completed transaction, with the additional advance made later in the year not affecting the tax consequences of the loan transaction completed earlier in the year.

Not surprisingly, the government cited *Cornelius* as requiring that the shareholders in *Brooks* recognize income to the extent the payments they received exceeded their bases in the debt at the time of payment.

The government conceded, however, that the advances made by the Brooks constituted open account debt, *i.e.*, no one advance constituted separate indebtedness. The court further noted that Treasury Reg. section 1.1367-2(a), concerning adjustments to the basis of debt (as issued in 1993, well after *Cornelius* was decided), provides that, for purposes of that provision, "shareholder advances not evidenced by separate written instruments and repayments on the advances (*open account debt*) are treated as a single indebtedness."

The court found the regulation not to be on point, because the circumstances did not support an argument for a restoration of basis of debt in the manner provided in Reg. section 1.1367-2(c), by reason of, for example, a pass-through of corporate items of income.

Based on the parties' stipulation that the debt was open account debt, however, the court found that the basis of the debt was properly computed by netting advances and repayments made during the same year. As the advances made at the end of each of the years at issue exceeded in each case the repayment at the beginning of the year, the taxpayers did not recognize gain by reason of receipt of repayment of the loans.

Observations

The extraordinarily favorable result in *Brooks* may have been a result of the relatively narrow argument made by the Commissioner. There is no indication, for example, that the government questioned whether each advance made by the shareholders was, in fact, a bona fide loan, rather than a mere stratagem to permit the pass-through of losses.

It may have been helpful to the taxpayers, in that regard, that the first advance was outstanding for more than a year, and that the corporation incurred losses in the year of the first advance (1997) or the following year -- and before repayment -- that were equal to or in excess of the funds advanced, suggesting a business need for those advances. Had each shareholder advance been made within a few days before the end of the year and repaid a few days after year-end, the argument for disregarding the advances as lacking in substance and as strictly tax-motivated might have been troublesome from the taxpayers' perspective.[1]

Further, it is not clear from the opinion in *Brooks* what circumstances led the government to concede that the shareholder advances constituted open account debt, in contrast to the *Cornelius* case, where the government did not concede this point and prevailed on the issue of recognition of income upon repayment. The debt may have been characterized as open account debt on the books and records of the corporation in *Brooks*, which might be helpful; that was not the case in *Cornelius* (where the books referred to the outstanding advances as "notes payable," though no notes were issued).

Conceivably the open account debt characterization may have been supported by reason of there having been outstanding loan balances at all times during the taxable years at issue, separate and apart from the sums referred to in the opinion. It is also possible that the government may have thought that the "open account" characterization was mandated by reason of the definition of open account debt in Reg. §1.1367-2(a).

When, in the context of planning for the funding needs and tax obligations of an S corporation and its shareholders, it becomes clear that the character of a shareholder advance as a separate debt or part of an overall open account debt may be relevant in the future when shareholder advances are repaid, it may be helpful to have the corporation and its lending shareholders enter into a loan agreement under which all shareholder advances will be made, and to have the loan agreement characterize the sum of such advances by any one shareholder as being part of a single open account indebtedness.

In all events, the delivery of separate notes to evidence each advance should presumably be avoided, since that would apparently prevent the debt from constituting open account debt as defined in Reg. section 1.1367-2(a) and therefore make it more likely that income will be recognized when an advance is repaid -- although it is unclear whether the definition in that regulation should be considered controlling for purposes of the issue before the court in *Brooks*.

Conceivably the government may even argue at some future time that *Brooks*, a memorandum decision of the Tax Court, reaches an incorrect result based on somewhat obscure references in the earlier *Cornelius* decisions of the Tax Court and Court of Appeals to a distinction between separate indebtedness and an "open account", without giving sufficient consideration to whether this distinction justifies a different result; and that the distinction referred to in *Cornelius* between an open account and separate debts should not in fact be controlling as to the issue of income recognition upon repayment of the debt that was before the court in the later case.

Regardless of whether *Brooks* proves to be the final word on this topic, it appears to constitute, at a minimum, a reminder of the continued potential importance of form in the determination of tax obligations.

1 *Compare Oren v. Commissioner*, 2004-1 USTC ¶50,165 (8^{th} Cir. 2004) (concluding, under somewhat different circumstances involving a circular flow of funds, that loans purportedly from a shareholder to two S corporations lacked economic substance and would therefore not be taken into account for purposes of the basis limitation rule of IRC §1366(d)).