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Basis issues of Loans to S Corporations

Many business owners and their advisors have the misguided belief that the S corporation business structure is preferable to the Limited Liability Company (LLC). I would like to discuss one small aspect of the difference between LLC structure and S corporation structure and highlight why I prefer LLC.

There are numerous occasions in the life of a business when it is necessary for an owner to loan it money. In the case of an LLC, the owner of an LLC can generally make loans or capital contributions to and receive payments back from the LLC without tax consequences. For the owner of an S corporation, complex computations must be made regarding the tax treatment of these transactions. When an owner of an S corporation provides funds to the corporation, attention must be paid to the form of the transaction to determine if it will be treated as a loan or as a contribution to capital. The following criteria, among others, may be used to determine if a transaction is a loan or a contribution to capital: a note evidences the transaction; the corporation is thinly capitalized; and if the corporation accounts for the transaction as a loan or a contribution to capital.

For purposes of this article, let's assume we have determined the funds provided by stockholder, Ed Smith, to his S corporation, Smith's Sporting Goods Inc., are loans evidenced by notes bearing adequate stated interest. Furthermore, let's assume that Smith's Sporting Goods Inc. has incurred losses that exceed the basis Ed has in his stock and that in 2003 the basis in Ed's loan to Smith's Sporting Goods Inc. has been reduced from an original \$10,000 basis to \$1,000. In 2004, Ed loans an additional \$20,000 to Smith's Sporting Goods Inc. The company has a loss for the year that equals \$15,000. The consequence to Ed's notes is as follows:

- 1) Ed's basis in the notes is reduced by a ratio proportionate to the basis in the loans. The formula for this computation is: the basis in the loan divided by the total basis in all the loans times the loss for the year (Reg. Section 1.1367-2(b)(3)).
- 2) The computations are as follows:
 - a. \$10,000 loan \$1,000 (basis)/\$21,000 (total basis in all loans) x \$15,000 (loss for the year) = \$714 (loss allocated and basis reduction of this note)
 - b. \$20,000 loan \$20,000 (basis)/\$21,000 (total basis in all loans) x \$15,000 (loss for the year) = \$14,286 (loss allocated and basis reduction of this note)

Therefore, after the allocation of the 2004 loss the basis in the \$10,000 loan is \$286 (\$1,000-\$714), and the basis in the \$20,000 loan is \$5,714 (\$20,000-\$14,286).

Now, let's assume that for 2005 there is net taxable income of \$1,000 and, in addition, Smith's Sporting Goods Inc, repays \$6,000 of the \$10,000 note. Since a note is being

repaid, the net taxable income is allocated entirely to the note being repaid to the extent its basis was previously reduced (Reg. Section 1.1367-2(c)(2)). The consequence to Ed's notes is follows:

- 1) The entire \$1,000 of gain is allocated to the \$10,000 note being repaid, bringing its basis to \$1,286.
- 2) The formula for the calculation of the return of capital received by Ed on the \$6,000 repayment of the \$10,000 note is: the principal received times the basis in the loan divided by its face.
- 3) The formula for the calculation of the installment gain recognized by Ed on the \$6,000 repayment of the \$10,000 note is: the total gain is the difference between the face of the contract and his basis in the contract and the recognized gain is the total gain times the amount of principal paid on the contract divided by its face (Rev. Rul. 64-162, 1964-1 C.B. 304). Therefore:
 - a. Return of capital is $\$1,286 \text{ (basis)} / \$10,000 \text{ (face)} \times \$6,000 \text{ (principal received)} = \772 .
 - b. Total gain is the face (\$10,000)-basis (\$1,286) = \$8,714 (total gain on the contract). $\$8,714 \text{ (total gain)} \times \$6,000 \text{ (principal received)} / \$10,000 \text{ (face)} = \$5,228$ (reportable gain).

Since the loan is evidenced by a note, the gain is capital resulting in a lower tax bracket. Had the loan not been evidenced by a note, the gain would have been ordinary and taxed at the higher ordinary income tax rate (Rev. Rul. 64-162, 1964-1 C.B. 304; Rev. Rul. 68-537, 1968-2 C.B. 372).

Had the notes not been repaid during 2005, the \$1,000 gain would be applied to increase the basis proportionately based on the amount of basis that each indebtedness has been reduced. The formula for this calculation is as follows; the total reduction of the note divided by the total reduction of all the notes times the gain to be allocated (Reg. Section 1.1367-2(c)(2)):

1. \$10,000 loan has a total reduction of \$9,714 ($\$9,000 \text{ (2003 reduction)} + \$714 \text{ (2004 reduction)}$)
2. \$20,000 loan has a total reduction of \$14,286
3. Therefore the combined reduction in loans is \$24,000
4. The basis restoration for the \$10,000 loan is $\$9,714 / \$24,000$ times \$1,000 or \$405. Accordingly, its basis is increased to \$691 ($\$286 + \405).
5. The basis restoration for the \$20,000 loan is $\$14,286 / \$24,000$ times \$1,000 or \$595. Accordingly, the basis of the \$20,000 loan is increased to \$6,309 ($\$5,714 + \595).

These computations -- time consuming, complex and costly for S corporations -- are completely avoided by LLCs, one of the many inherent advantages of this business structure over an S corporation.