Subchapter S Loss Limitations under Sections 1366(d) and 465

Tulane Tax Institute

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John S. Harper
Morrison & Foerster, LLP
McLean, VA
jharper@mofo.com
Discussion Topics

Pass-through loss limitations for S corporation shareholders
  • §1366(d) basis limitation and proposed amendment to Regs. §1.1366-2
  • §465 at-risk amount limitation
  • §469 passive activity loss limitation

Section 1366(d) limitation and economic outlay theory
Section 465 statutory and regulatory evolution
At-risk amount defined – contributions and borrowings and adjustments
Section 465 provisions relevant to S corporations
  • Borrowing from persons with an interest in the activity
  • Substance over form, temporary basis increases
  • Guarantees and protection against loss
  • Definition of activity and grouping of activities

Example: low basis founder with suspended losses
Other considerations related to at-risk rules
  • S corporation as parent of multiple DREs
  • Gains on stock as income from the activity
  • Computational errors in basis and at-risk amounts
Loss deferral systems for S corporation shareholders

Section 1366(d) – basis in stock and debt

- Literally adjusted tax basis
- “Economic outlay” judicial gloss for related party funds
- Pending proposed regulations eliminates judicial gloss but not uncertainty

Section 465 – amount at-risk

- Modified tax basis analysis
- Recapture of prior losses on reduction of at-risk amount
- Activity-based analysis – undefined grouping rules

Section 469 – passive activity limitation

- Income and loss basket characterization
- Loss offsets across multiple activities within baskets
- Material participation standards applied by activities
§1366(d) economic outlay – cash guarantee performance

Senate Rept. 1983, 85th Cong., 2d Sess. (1958)

The amount of the net operating loss apportioned to any shareholder . . . is limited under section 1374(c)(2) to the adjusted basis of the shareholder's investment in the corporation; that is, to the adjusted basis of the stock in the corporation owned by the shareholder and the adjusted basis of any indebtedness of the corporation to the shareholder. [Emphasis added]

Rev. Rul. 70-50, 1970-1 CB 178

Bank loan to S corporation guaranteed by shareholder. Losses exceeded stock basis at end of year 1. In year 2, S corporation defaulted on the loan and shareholder paid the debt in satisfaction of his guaranty.

After performance on guarantee, by subrogation, the S corporation’s debt to Bank is then owed directly to the shareholder and included shareholder’s basis under predecessor of §1366(d).
Rev. Rul. 75-144, 1975-1 CB 277

Same facts as Rev. Rul. 70-50, except that instead of satisfying guaranty with money, the shareholder executed his own promissory note for the full amount due and substituted it for the note of the corporation. The bank accepted the shareholder’s note in satisfaction of the guaranty and relieved the corporation of its liability on the old note. The shareholder made no payment on his own note until a later year.

Acceptance of the shareholder’s note by a bank and release of S corp caused the indebtedness of S corp to be to the shareholder, creating basis under section 1366(d).

Query: How is this transaction different from shareholder exchanging his personal note with for an S corp note, which S corp delivers to the bank in satisfaction of its debt?
§1366(d) economic outlay – related lender enforcement

*Underwood v CIR*, 535 F.2d 309 (5th Cir. 1976)

The surety or guarantor [of an S corporation's debt] may never be called upon to pay the corporate debt; consequently, unless that eventuality transpires, he will not have increased the basis of his investment in the corporation. . . . [O]nce he does pay the obligation of his Subchapter S corporation, the shareholder will have increased the adjusted basis of investment in his corporation, and a basis-giving indebtedness for purposes of section 1374(c)(2) will have arisen.

[The taxpayers] merely exchanged demand notes between themselves and their wholly owned corporations; they advanced no funds to either [the C corporation or the S corporation]. *Neither at the time of the transaction, nor at any other time [during the relevant years] was it clear that the taxpayers would ever make a demand upon themselves, through [the C corporation], for payment of their note.*

In [Rev Rul. 75-144] the obligee on the shareholder's note was an outsider, a bank, which stood ready to enforce the obligation. Hence it was clear at the time the substitution occurred that at some future date payment would be required. *[Emphasis added]*
§1366(d) economic outlay – unperformed guarantee

Leavitt v CIR, 875 F.2d 420 (4th Cir., 1989)

To increase the basis in the stock of a subchapter S corporation, there must be an economic outlay on the part of the shareholder. . . . A guarantee, in and of itself, cannot fulfill that requirement. The guarantee is merely a promise to pay in the future if certain unfortunate events should occur. At the present time, the appellants have experienced no such call as guarantors, have engaged in no economic outlay, and have suffered no cost. [Emphasis added]
We think it significant that, as between CCC and CMB, CCC remained liable as a surety of the obligation of CMB to petitioner; there was no novation relieving CCC of its liability to petitioner as a primary obligor.

... it is clear that the basis of *Gilday* and Rev. Rul. 75-144 is that the substitution of the shareholders as the sole unconditional obligors to the bank and of the S corporation as the sole unconditional debtor to the shareholders constituted a constructive furnishing by the shareholder of the funds previously loaned by the third party bank. [Emphasis added]
§1366(d) economic outlay – economic substance

Oren v CIR, TC Memo 2002-172

The loan transactions did not have a net economic effect. None of the $4 million that Dart lent to Mr. Oren was retained by a party other than Dart. Indeed, the loan proceeds originated with Dart and ended with Dart. . . . The economic positions of the parties did not change. . . .

. . . we hold that the loans that Mr. Oren made to HL and HS did not increase petitioners' basis in those companies for purposes of section 1366(d)(1)(B). . . .

We also hold that petitioners were not at risk for the amounts borrowed by Mr. Oren for use in HL and HS. Therefore, petitioners' loss deductions from those companies are limited under section 465(a) to amounts for which petitioners are otherwise at risk. [Emphasis added]

NB: Economic effect as if Oren had contributed his personal note to HL for an equivalent debt from HL, and then HL transferred the Oren note to Dart in exchange for a Dart note.
CoBank specifically acknowledged that RFB would advance the proceeds directly or indirectly to the Alpine entities. “Advances” from RFB out of CoBank proceeds were made to Alpine, and at year-end characterized as loans from RFB to Broz, and loans from Broz to Alpine. (Alpine Investments later formed to be the debtor to RFB and the creditor to Alpine.) Apparently notes were issued from Broz to RFB, and interest was accrued and reported on these notes.
Respondent contends that the payments did not create basis. Instead, [Broz] served as a mere conduit to the transfer of loan proceeds from RFB to Alpine. Respondent further asserts that petitioners did not make any economic outlay that would entitle them to increase their basis in the S corporation.” [Emphasis added]

A taxpayer makes an economic outlay for purposes of debt basis when he or she incurs a “cost” on a loan or is left poorer in a material sense after the transaction. The taxpayer may fund the loan to the S corporation with money borrowed from a third-party lender in a back-to-back loan arrangement. The taxpayer has not made an economic outlay, however, if the lender is a related party and if repayment of the funds is uncertain.

Petitioner never substituted himself as “lender” [to Alpine] in the place of RFB. There is no evidence that the Alpine entities were indebted to petitioner rather than to RFB. Interest on the unsecured notes accrued and was added to the outstanding loan balances. No payments were ever made. Moreover, petitioners signed the promissory notes on behalf of all the entities, making it unlikely that any of the entities would seek payment from petitioners. . . . The promissory notes, therefore, do not establish bona fide indebtedness between petitioners and Alpine.

We therefore will apply the step transaction doctrine and ignore petitioners' participation in the advances from RFB to Alpine. [Emphasis added]
§1366(d) economic outlay – proposed regulations

Preamble:

These proposed regulations require that loan transactions represent bona fide indebtedness of the S corporation to the shareholder in order to increase basis of indebtedness; therefore, an S corporation shareholder need not otherwise satisfy the “actual economic outlay” doctrine for purposes of section 1366(d)(1)(B).

Text of Prop. Reg. §1.1366-2(b) (June 12, 2012):

(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 (as defined in § 1.1011-1 and as specifically provided in section 1367(b)(2)) 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.

(ii) Guarantees. A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. When a shareholder makes a payment on bona fide indebtedness for which the shareholder has acted as guarantor or in a similar capacity, based on the facts and circumstances, the shareholder may increase its basis of indebtedness to the extent of that payment.
Observations regarding the proposed regulation:

- Preamble, but not text, indicates that the purpose is to eliminate the “economic outlay” question as a separate test, and to eliminate uncertainty caused by the “poorer in a material sense” rationale used by some courts.

- The regulation only deals with basis in debt, and does not deal with basis in stock, leaving some uncertainty whether economic outlay may still apply in that context.

- Determination of whether debt exists to the shareholder is left as a factual question, presumably under applicable state law. Incorporated pocket book cases address whether a debt is owed to the shareholder rather than the lending corporation.

- Example 3 illustrates and approves a loan from a controlled entity to a shareholder, and then from the shareholder to the S corporation.

- Example 4 illustrates and approves a loan from a commonly controlled entity, followed by the lending entity’s distribution of the S corporation’s note to the common shareholders. Amount of distribution and basis is presumably FMV determined under §301(d).

- There is no example of a debt restructuring in which there is a circular flow of funds to replace loans from a commonly controlled entity with loans from a shareholder.
History of §465

1976 Tax Reform Act

- Limited to named types of tax shelter investments (motion pictures, farming, oil, equipment leasing, oil, gas and geothermal exploitation)
- Applied to S corporations and corporation meeting §542 PHC stock ownership test
- Disallowed borrowing from §267 related parties

1978 Revenue Act

- Expanded to cover all activities
- Real estate and corporate equipment leasing excepted

1982 Subchapter S Revision Act

- Eliminated application to S corporations per se at the corporate level, but still possible covered under §542
- Allowed aggregation within the 5 original activities
History of §465

1984 Deficit Reduction Act
  • Clarified nonapplication to S corporations
  • Allowed borrowing from §267 related parties not having an interest in the activity

1986 Tax Reform Act
  • Expanded to cover real estate activities (with qualified non-recourse financing rules)
  • Enactment of §469 passive activity limitation
Regulations under §465

  • Still outstanding – transitional implementation rules

Prop. Regs. §1.465-1 through -95 [NPRM (June 5, 1979)]
  • Did not reflect any changes made by the 1978 amendments:
    • “The proposed regulations do not provide guidance with respect to these [1978] amendments. This guidance will be provided in a later regulations project.”
    • Weight of proposed regulations: “position of IRS on brief”

Temp. Regs. §1.465-1T [TD 8012 (March 7, 1985)]
  • Applicable indefinitely
  • Applied aggregation rules to the five original activities

Regs. §1.465-8 and -20 [T.D. 9124 (April 30, 2004)]
  • Expanded the application of the disallowance of loans from persons with an interest in the activity to all covered activities
At-risk amount defined

“Loss” absorption limited to “amount at risk” in the “activity”

• Loss is excess of deductions over income
• After all other limitations on deductions (except §469)
• Suspended losses treated as re-incurred in next year for retest

“Amount at risk” includes:

• Amounts “contributed” to the activity
• Amounts “borrowed” with respect to the activity

“Contributions” is a term of art

• Must be sourced from “personal assets” of the taxpayer
• Loans to the S corporation are treated as “contributions” to the activity
• Purchase price “paid” for an interest in an activity is a “contribution”
At-risk amount defined - contributions

Prop. Regs. 1.465-9(f):

- Borrowed amounts contributed are not contributions because not from "personal assets"
- "Personal funds" and "personal assets" of a taxpayer refer to funds and assets which are owned by the taxpayer; not acquired through borrowing; and have a basis equal to their fair market value.

Tracing of fund sources implicitly required

- No specified rules
- Comparison to Regs. §163-8T (used for §469)?
- Purpose-based tracing as in §265?
  - Indebtedness "incurred or continued to purchase or carry" tax exempt obligations
  - "Taxpayer's purpose" in incurring or continuing each item of indebtedness determined under all the facts and circumstances (Rev. Proc. 72-18)
At-risk amount defined - borrowed amounts

Excluded liabilities
- Amounts borrowed from a person with an interest in the activity other than a creditor
- Amounts “protected against loss”

Recourse liabilities (Prop. Regs. §1.465-24)
- Any liability incurred “in the conduct” of an activity, “for use” in the activity
- Implicitly includes liabilities that are not borrowings
- Only to the extent that the taxpayer is “personally liable”
- Shareholder’s amount at risk is not increased by any liability incurred by the corporation from persons other than the shareholder

Nonrecourse liabilities (Prop. Regs. §1.465-25)
- Limited to FMV of pledged property that is not used in the activity
- Cross-collateralized debt prohibited by §465(b)(2)
- Prop. Regs. §1.465-25(b)(3) - cross collateralization, Example 6 [Slide 25]
- Rev. Rul. 77-401 – business purpose [Slide 26]
§465 – Related party borrowing

Original rule and 1984 revision

• Before DRA 1984, loans from any “related” person were excluded from at-risk amount.

• §465(b)(3)(B) originally defined “related person” by reference to §267(b).

• Amended §465(b)(3)(A) narrowed this rule to refer to loans from “any person who has an interest in such activity or from a related person to a person (other than the taxpayer) having such an interest.

• Amended §465(b)(3)(C) expanded definition of person related to the lender:
  • Relationships specified in §267(b) or §707(b)(1), or between persons engaged in trades or business under common control (within the meaning of §52(a) and (b)
  • For purposes of §267(b) or §707(b)(1), substituted more than 10% for more than 50%.
§465(b)(3)(A) – Related party borrowing

§465(b)(3)(A) lender with an interest rule as applied to additional covered activities per TRA 1978

- § 465(c)(3)(A) was added by TRA 1978 to extend application of §465 to most activities other than real estate.

- § 465(c)(3)(D) also was added by TRA 1978 provided that §465(b)(3)(A) applies to newly covered activities “only to the extent provided in regulations prescribed by the Secretary”.

- Alexander v CIR, 95 T.C. 467 (1990) -- held §465(b)(3)(A) “lender with an interest” rule inapplicable for new activities covered by §465 unless regulations are adopted that so provide.

- 2004 finalized Regs. §1.465-8 to implement §465(b)(3)(A) for all activities: “This section applies to amounts borrowed for use in an activity described in section 465(c)(1) or (c)(3)(A).”
§465 - Related party borrowing

2004 final regulations: lenders with an interest in the activity

- Regs. §1.465-8(a)(1):

  “Amounts borrowed with respect to an activity will not increase the borrower's amount at risk in the activity if the lender has an interest in the activity other than that of a creditor or is related to a person (other than the borrower) who has an interest in the activity other than that of a creditor.”

  “This rule applies even if the borrower is personally liable for the repayment of the loan or the loan is secured by property not used in the activity.”

- Regs. §1.465-8(b)(1): “If a borrower is personally liable for the repayment of a loan for use in an activity, a person shall be considered a person with an interest in the activity other than that of a creditor only if the person has either a capital interest in the activity or an interest in the net profits of the activity.”

- Regs. §1.465-8(b)(2): “A capital interest in an activity means an interest in the assets of the activity which is distributable to the owner of the capital interest upon the liquidation of the activity.”

- Regs. 1.465-8(b)(2): Shareholders of an S corporation are considered to have capital interests in the activities conducted by the S corporation.
§465 - Related party borrowing after 2004 regulations

Amounts borrowed from persons with an interest in the activity

Not at risk
Lender has an interest in the activity

Not at risk
Mother is related to a Father (other than Son) who has an interest in the activity
§465 - Related party borrowing after 2004 regulations

Amounts borrowed from persons with an interest in the activity

At risk
Lender not related to a person that has interest in the activity (other than the borrower’s interest)

Not at risk
Father is related to a person (Grandson) who has an interest in the activity (other than the borrower’s interest)
**§465(b)(2) - Cross-collateralized non-recourse debt**

Liability to Lender 1 secured by Asset X does not increase amount at risk because Asset X used in the activity. Use of borrowed $8,000 directly in the activity would not increase amount at risk.

Use of borrowed amount secured by activity Asset X to purchase a personal asset decreases amount at risk by $8,000. Pledge of personal Asset Y for nonrecourse liability incurred for use in the business generally would increase the at risk amount by FMV of the property $10,000. Should be a net increase of $2,000.

“No property shall be taken into account as security if it is directly or indirectly financed by indebtedness which is secured by property used in the activity.”
• Loss of $46 incurred by AB during the year
• Neither debt of AB is included in the partner’s basis in AB interests
• Both cash amounts paid by AB are included in at-risk amount – investment in bonds was not excluded on grounds of not being devoted to the activity
• Recourse loan from broker was excluded from at-risk amount – analysis not stated, apparently based on lack of business purpose for the loan (no net interest income on bonds)
• Alternative rationale may be that the amount borrowed was not used in the activity.
Increased by income from the activity and decreased by losses allowed

- Includes tax-exempt income
- Includes gain recognized from the disposition of a property or interest in the activity (Prop. Regs. §1.465-12 and -66)
- Requires allocation of income to various activities

Increased by additional includible borrowing and decreased by payments against previously included borrowing

- Payments from personal funds do not change amount at risk
- Payments with funds from non-includible borrowing (e.g., a nonrecourse loan not secured by personal property) decrease amount at risk
- Change in status of recourse creditor to creditor having an interest in the activity would reduce the amount at risk
- Requires allocation of borrowing to various activities to track relevant changes

Increased by additional contributions and reduced by withdrawals from the activity

- Redeployments of funds within the entity to be tracked
- Nonincluded borrowing against interests in the activity is a withdrawal of funds

Excess prior losses over adjusted at-risk amount causes income recapture

- Recapture is not “income from the activity” and does not increase at-risk amount
§465 - Notable provisions of regulations

Prop. Regs. §1.465-10: Rules relating to S corporations and their shareholders

- Obsolete – States the original rule that applied §465 both at the S corporation level and at the shareholder level, and before Subchapter S Revision at of 1982

- Prop. Regs. §1.465-10(c): “The amount at risk of a shareholder of an electing small business corporation . . . shall be adjusted to reflect any increase or decrease in the adjusted basis of any indebtedness of the corporation to the shareholder described in section 1374(c)(2)(B).”

- Wyk v CIR, 113 T.C. 440 (1999) – Prop. Regs. §1.465-10(c) does not address situations in which the source of funds loaned violate some other exclusion rule. – in this case because borrowed from a related party with an interest in the corporation, basis in debt was excluded from at-risk amount.

- Compare consolidated return rules for parent corporation, permitting guaranteed debt to be treated as at risk (assuming not otherwise protected against loss).
§465 - Notable provisions of regulations

Substance over form – heads I win, tails you lose?

- §465(b)(4): “Notwithstanding any other provision of this section, a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.”

- Prop. Regs. §1.465-1(b): “In applying section 465 and these regulations, substance will prevail over form. Regardless of the form a transaction may take, the taxpayer's amount at risk will not be increased if the transaction is inconsistent with normal commercial practices or is, in essence, a device to avoid section 465.”

- Cf. Temp. Regs. §5.1502-45(a)(5): “Substance over form. Any transaction or arrangement between members (or between a member and a person that is not a member) which does not cause the parent to be economically at risk in an activity of a subsidiary will be treated in accordance with the substance of the transaction or arrangement notwithstanding any other provision of this section.”
§465 - Notable provisions of regulations

Year-end increases in at-risk amount

Prop. Regs. §1.465-4(a)

• “Increases in the amount at risk occurring toward the close of a taxable year which have the effect of increasing the amount of losses which will be allowed to the taxpayer under section 465 for the taxable year will be examined closely.”

• “If the event which increases the amount at risk at the close of the taxable year will be accompanied by an event which decreases the amount at risk after the close of the taxable year, these amounts will be disregarded.”

• Dual requirements: Business purpose and “not a device for avoiding section 465”
Protection against loss (guarantees, subrogation, etc.)

- Prop. Regs. §1.465-6(a): “Assets of a taxpayer (including money) contributed to an activity shall not be treated as increasing the taxpayer's amount at risk to the extent the taxpayer is protected against loss of such assets.”

- Prop. Regs. §1.465-6(d): “If a taxpayer guarantees repayment of an amount borrowed by another person (primary obligor) for use in an activity, the guarantee shall not increase the taxpayer's amount at risk.”

- Prop. Regs. §1.465-6(d): “If the taxpayer repays to the creditor the amount borrowed by the primary obligor, the taxpayer's amount at risk shall be increased at such time as the taxpayer has no remaining legal rights against the primary obligor.”

- Cf. Temp. Regs. §5.1502-45(b)(2): “If a parent guarantees a loan by a person other than a member to a subsidiary, the loan increases the amount the parent is at risk in the activity of the subsidiary.”
Activity definition (not developed)

- Prop.Regs. §1.465-9(c): “For the purposes of the regulations under section 465, unless expressly provided otherwise, use of the term ‘activity’ shall refer to an activity which is described in section 465(c)(1).” No discussion of expansion by §465(c)(3).

- Prop.Regs. §1.465-9(d): “For the purposes of the regulations under section 465, unless otherwise stated, it is assumed that an entity conducting an activity is engaged only in that one activity.”
  - Implies tracing rules required to determine contribution of assets to an activity
  - After termination of application at the S corporation level, S corporation shareholders would not have any indication of separate “activities” of the S corporation.

- Prop.Regs. §1.465-22(a): “A contribution by a partner to a partnership conducting only one activity is a contribution to the activity.”

- Cf. Regs. §1.469-4 (definition of “activity” under §469)
§465 - Notable provisions of regulations

Activity aggregation and segregation (not developed)

- Section 465(c)(3)(C): The Secretary “shall prescribe regulations” under which activities described in Section 465(c)(3)(A) “shall be aggregated or treated as separate activities.”

- Prop. Regs. §1.465-13(c):
  - “Proper allocation rules are necessary if assets or personnel are used either in two or more separate activities referred to in section 465(c)(2), or in one or more activities referred to in section 465(c)(2) and an activity to which section 465 does not apply.
  - In such a case the deductions attributable to the use of these assets or personnel must be allocated between the activities on a reasonable basis.”

- Rev. Rul. 77-401, 1977-2 CB 215: [Slide 26]
  - Recourse liability of general partnership engaged in construction with nonrecourse financed equipment, that was used to finance purchase of Treasury notes that secured the recourse liability did not increase partners’ basis in partnership interest (or at-risk amount, apparently)
  - Probably would be viewed as not being borrowed for use in the “activity” or contributed to the “activity” that produced the loss.

- Prop. Regs. §1.465-22(a): Note payable to a partnership for which a partner is personally liable does not increase at-risk amount until the proceeds of the note are actually devoted to the activity.
Business activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469.

Relevant facts and circumstances (nonexclusive):
- Similarities and differences in types of trades or businesses
- Common control and common ownership
- Geographical location;
- Interdependencies between the activities

Restricted grouping of rental activities with other business activities (but may not be applicable for section 465 purposes)

An entity subject to section 469 first groups its activities at the entity level. The entity owner may then group the entity activities (as grouped by the entity) with activities conducted directly by the shareholder or partner, and with activities conducted through that entity and other section 469 entities.

The entity owner may not treat activities group together by a section 469 entity as separate activities.
Effective for calendar year 2011, regroupings and elimination or addition of activities in pre-existing groupings must be disclosed on tax returns. (Pre-existing groupings are not required to be disclosed.)

Activities are treated as separate activities if not disclosed as a group, subject to IRS authority to require grouping whenever appropriate.

Pass-through entity owners do not need to disclose the grouping at the entity level, but have long been required to be broken out by separate activities on Schedule K-1, so that a failure to state the income and deductions for separate activities at the corporate level in effect would be a decision to group all the activities together.

For passive activity rules, groupings are relevant to material participation determinations (motivating combinations of activities) and allowing losses on disposition of all interests in a separate activity (motivating separation of activities).

At risk determinations will be motivated by considerations of whether at-risk amounts can be increased by income from the activity (motivating grouping), and whether an interest in an activity or its assets can be counted at FMV of the pledged property (motivating separation of activities).
Grouping of activities for at-risk testing

This structure would have violated the economic outlay requirement as it was being applied, because it was not clear that S Corp 1 would actually enforce its debt against Stockholder. [Compare Broz v. CIR, slide 11 where the court stated as an alternative rationale that Broz failed to show step 2 actually occurred.]

Under the proposed regulations, step 3 (Stockholder loan to S Corp 2) will create debt basis under §1366(d).

Different answer if Stockholder Step 3 were a contribution to capital of S Corp 2?
Loan to S Corp 1 replaced with non-recourse loan to Stockholder secured by S Corp 1 stock.

Under the proposed regulations, step 2 (Stockholder loan to S Corp 2) will create debt basis for §1366(d).

Whether Stockholder is at-risk in S Corp 2 depends on whether Activity A is separate from Activity B.
Petitioners contend that RFB stock is not property used in the business [of Alpine] for at-risk purposes because the stock represents an ownership interest in the business that can be sold or transferred without affecting corporate assets [of Alpine]. According to petitioners, stock is therefore inherently separate and distinct from the activities of a corporation and the pledge of stock of the related corporation should allow petitioners to be treated as at risk. We disagree.

We reject petitioners' narrow interpretation of property used in the business. Pledged property must be “unrelated to the business” if it is to be included in the taxpayer's at-risk amount. . . . The Alpine entities were formed by petitioner to expand RFB's existing cellular networks. RFB also used some of Alpine's digital licenses to provide digital service to RFB's analog network areas. RFB then allocated income from the licenses back to Alpine. The RFB stock is related to the Alpine entities.
Comparison of §465 to §1366(d) basis limitation

Non-recourse loans

• Basis arises from nonrecourse loans but will not increase the amount at risk under §465 (except to extent of pledged property not used in the activity).

Recourse loans

• Basis arises from recourse loans from persons with an interest in the activity, but do not increase amount at risk under §465.

Activity Segregation

• Basis determinations do not require a segregation of investments and income among activities

Ordering rule

• Stock basis is reduced by amounts of losses that are disallowed under §465

Post-termination transition period rules are more limited than §465 carryforward

“Section 465 does not apply for other purposes, such as determining adjusted basis.” (Prop. Regs. §1.465-1(e))
Suspended loss example - §1366(d) and at-risk amount

- Entire loss allocated to Founder is suspended under §1366(d)
- Entire loss allocated to Investors is suspended – $50 under §1366(d) and $100 under §469
- Capital gain on Founder’s stock sale, loss disappears – loss of rate leverage
- Sale of Activity A LLC – separately stated capital gain income, and ordinary loss
Founder’s alternatives to increase §1366(d) basis

1. Contribution of $150 cash to capital for additional stock
2. Cash loan $150 to S Corporation for debt instrument
3. Purchase $150 of stock from investors for a personal note (recourse or nonrecourse)

Financing alternatives:
- Founder’s personal assets
- Founder’s recourse note held by S corporation secured by Founder stock or assets
- Founder’s nonrecourse note held by S corporation secured by Founder stock or assets
- Founder’s borrowed cash from third parties (including refinance of Bank debt)
Founder’s cash contribution and at-risk issues

$1366(d) – $0 suspended
$465 – N/A
$469 – N/A

$150 paid for stock or secured note

$200 loan

Is Founder now at risk?
• Source of Founder’s cash?
• Use of cash by S Corp?
• Location of cash in S corp or lower tier DRE?
• Effect of security pledged by S Corp on the note issued?
• Effect of put or call on the stock issued to Founder?

§1366(d) – $50 suspended
§465 – N/A
§469 – $100 suspended PAL

$300 prior year loss

Activity A (DRE)

S Corp

Investors

Bank

Founder
Includible sources of funds
- Personal assets contributed (bank account)
- Personal recourse borrowing (back-to-back) from party without an interest in Activity A
- Assumption of Bank debt (recourse) if Founder has primary liability, S corp is released
- Assumption of Bank debt (nonrecourse) if personal assets not used in the activity are pledged (up to current FMV)

Non-includible sources
- Personal guarantee of Bank debt (not a borrowing yet)
- Transfer of personal recourse note to S Corp (for stock or debt), pledged to Bank by DRE
- Temporary contributions or without business purpose
- Non-recourse borrowing secured by S corp stock
- Recourse borrowing from investors (or their 10% related persons under §267 or §707)
Founder’s at-risk issues – use of funds

Includible uses of funds (if source is includible)
- In all cases investment must be “used in” Activity A
- Investment used to pay down Bank debt
- Purchase of S corporation stock or debt from Investors

Non-includible uses (even if source is includible)
- Funds held by S Corp but not contributed to DRE?
- Funds contributed to DRE but not invested in activity A?
Funding between Qsubs and DREs

Activity A FMV is $1,000, and basis is zero; all cash flow is distributed to Stockholder annually; S Corp borrows from Lender to fund Activity B, which produces a loss for the year.

Borrowing against Activity A value should be treated as personal funds if it is a separate activity from Activity B, and includible in the at-risk amount for Activity B.

If Lender requires security interest in Asset B assets as well? How much of funding to Activity B is at-risk? Does this result in cross-collateralization?

Is it relevant that S Corp and not the DRE is the obligor to Lender?
Gains on S corporation stock is income from the activity

Stockholder basis in S Corp is zero and there are suspended losses of $1000
Stockholder has ordinary income to shelter from other sources and is not subject to §469 limitations
Stockholder has a more than 1 year holding period in stock of S corporation
S Corp borrows $1000, guaranteed by Stockholder, and distributes the cash to Stockholder, triggering gain recognition to Stockholder of $1000. This is income from the activity (assuming that the only assets of S Corp are devoted to a single activity)

Payment to Lender in Step 3 is treated as contribution to capital to S corporation, and increases basis under 1366(d), allowing the loss to pass through to Stockholder

Achieves tax rate arbitrage of capital gain and ordinary loss, timed to offset other income

See Nondocketed Significant Advice Review (NSAR) 020039 (11/20/2001) (gain recognized under §301(c)(3) treated as income from the activity for purposes of §465)

See also Rev. Rul. 95-5 (§301(c)(3)(A) gain treated as gain from a disposition of interest in an S corporation for purposes of §1.469-2T(e) (3) and under §1.469-2T(e)(3) the gain will generally be treated as gain from the disposition of an interest in each of the corporation’s activities)
Effect of computational errors related to amount at risk

*Barnes v CIR, T.C. Memo. 2012-80 (3/21/2012)*

Stockholder claimed a loss pass-through for 2003. IRS contended there was insufficient stock basis in 2003 to allow the pass-through loss.

Taxpayer’s higher basis computation for 2003 was a result of asserted basis adjustments for two prior years’ errors:

- over-reported pass-through income (failure to claim an available 1995 suspended loss carryover should increase basis because it was reported in income)

- underreported pass-through loss (should not reduce stock basis because it was not claimed)

§1367(b)(1): no basis increase for unreported pass-through income.

All other basis adjustments follow the correct amounts of income and loss for the year, whether or not correctly reported by the shareholder.

Prop. Regs. §1.465-22(c)(1) and (2):

- Amount at risk increased by an amount equal to the excess of all items of income “received or accrued” from the activity during the taxable year over allowable deductions which are allocable to the activity for the taxable year.

- Amount at risk decreased by the amount of loss from the activity “allowed” as a deduction under section 465(a).