

A Journey Through Subchapter S / A Review of The Not So Obvious & The Many Traps That Exist For The Unwary: Part XI - A Shareholder of an S Corporation Cannot Take Losses in Excess of the Shareholder's Stock Basis

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In this Part XI of my multi-part series on some of the not-so-obvious aspects of S corporations, I explore a topic that should be obvious but which appears to be ignored by many taxpayers and their tax advisers - accurate computation of shareholder basis for purposes of taking losses flowing through from the S corporation is important.

Background

In 2005, the Internal Revenue Service launched a study to assess the reporting compliance of S corporations. The study, carried out under the National Research Program ("NRP"), involved the examination of roughly 4,800 randomly selected S corporation returns from tax years 2003-2004. Based upon the portions of the study disclosed by the Service to the public, six major areas of noncompliance in the S corporation arena were detected:

1. Insufficient S corporation stock basis to deduct losses passed through from S corporations;
2. Unreasonably low compensation;
3. Noncompliance with qualification rules;
4. Failure of shareholders to report income passed through from S corporations;
5. Improper tax-free treatment of fringe benefits provided to S corporation shareholder/employees and their families; and
6. Conversion of nondeductible personal expenses into deductible business expenses.

In December 2009, the U.S. Government Accountability Office ("GAO") published a report entitled "Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules" (the "GAO Report"). The GAO Report was submitted to the United States Senate Committee on Finance.

The GAO Report was the result of a study on long-standing S corporation income and employment tax noncompliance issues. The Senate Finance Committee initiated the report, asking the GAO to analyze the types of S corporation noncompliance, what the IRS has done to address noncompliance and options to improve compliance. It also asked the GAO to analyze the extent of shareholder compensation noncompliance. Although the report was based primarily on the data from the NRP, it also reflects the GAO's interviews of CPAs, legal professionals, small business representatives, and IRS officials and examiners, as well as representatives of several of the companies selected for audit during the NRP.

One of the major areas of noncompliance revealed in the NRP and the GAO Report was shareholder use of S corporation losses in excess of basis. Upon analyzing IRS annual examinations of individual tax returns that closed for fiscal years 2006 through 2008, the GAO determined the amount of misreported losses that exceeded basis limitations was more than \$10 million, or approximately \$21,600 per taxpayer. The GAO suggested this type of noncompliance is a consequence of shareholder, not S corporation, responsibility to calculate and track basis.

To help alleviate this type of noncompliance, the GAO recommended, among other recommendations, Congress pass a law requiring S corporations to calculate each shareholder's basis and report that basis on the shareholder's Schedule K-1. Although such a requirement may be burdensome on S corporations, it would likely reduce noncompliance because basis calculations would be reported both to the shareholders and the Service. Moreover, it would parallel the partnership requirement to report partner capital accounts. To date, legislation of this nature has not made its way into law.

Kerzner - An Illustrative Case

Kerzner v. Commissioner, TC Memo 2009-76 (April 6, 2009) illustrates one aspect of the issue identified by the NRP and the GAO Report. Keeping track of stock basis and only deducting losses from an S corporation to the extent of basis is imperative.

Mr. and Mrs. Kerzner were equal partners in a partnership that owned a building. The partnership leased the building to an S corporation that was owned equally by two shareholders, Mr. and Mrs. Kerzner. Over the years, the partnership loaned money to the Kerznors. In turn, the Kerznors loaned the money to their S corporation, which it used to pay rent to the partnership.

At the end of each year, promissory notes were drafted to document the loans; some of the notes stated an interest rate, some did not. Even though the notes required payment of principal, virtually no payments of interest or principal were ever made because the notes each year were replaced with new notes before any payment under the existing note was due.

The S corporation incurred large losses from its operations. The Kerznerns claimed stock basis in the loans they made to the S corporation. With the stock basis, they claimed the losses on their individual IRS Form 1040. Upon audit, the Service claimed the Kerznerns' extension of credit to the S corporation did not constitute valid loans because the advances lacked economic substance. Consequently, the Service denied the losses the Kerznerns claimed on their individual tax return, concluding they did not have adequate basis to absorb the losses.

To understand the IRS' position in the case, two points of law need to be comprehended:

1. First, IRC §1366(d)(1) tells us the losses taken by the Kerznerns cannot exceed their adjusted basis in the stock, plus their adjusted basis in any loans from them to the corporation; and
2. Second, basis is only obtained from loans if (i) the corporation owes the debt directly to the shareholders; and (ii) the shareholders really made an economic outlay that rendered them less wealthy (i.e., left them with fewer funds). There must be economic substance-the loans must be real.

In the *Kerzner* case, the money started with the partnership and ended with the partnership.

The Tax Court appears to have focused on three aspects of the matter to conclude there was no economic substance to the loans, namely: (i) no cash ever actually exchanged hands as the funds started with the Kerznerns and ended with the Kerznerns; (ii) no payments were ever made on the loans because the notes were replaced with new notes before any payments were due on the existing notes; and (iii) the notes were an after-the-fact thought as they were drafted at or after the end of the year rather than at the time of the extension of credit.

Consequently, the Tax Court disallowed the pass-through losses after reaching the conclusion that the Kerznerns lacked stock basis.

The Kerznerns could possibly have changed the outcome had they approached the matter differently. At least three approaches would have saved the day for them:

1. For one, they could have caused the partnership to actually distribute funds to them. Following receipt of the funds, they could have transferred the funds to the S corporation as a loan reflected in contemporaneous documentation (i.e., a promissory note and a resolution of the board of directors authorizing the borrowing). Then, they would have needed to actually require the corporation to make regular payments of principal and interest.
2. Alternatively, the Kerznerns could have personally borrowed money from a bank and loaned the proceeds to the S corporation in accordance with contemporaneous documentation (i.e., a promissory note and a resolution of the board of directors authorizing the borrowing), and required the corporation to make regular payments of principal and interest.

3. Last, the Kerzners could have used their own resources and loaned money to the S corporation in accordance with contemporaneous documentation (i.e., a promissory note and a resolution of the board of directors authorizing the borrowing), and required the corporation to make regular payments of principal and interest.

Conclusion

At least two pearls of wisdom should be taken away from this blog post, namely: (i) a shareholder of an S corporation cannot take losses in excess of the shareholder's stock basis; and (ii) keeping track and contemporaneously documenting stock basis is important. This is likely one of at least six areas of S corporation noncompliance that has caught the eye of the Service.

I hope this Part XI of my multi-part series on S corporations was helpful. Stay tuned! There will more posts to follow.

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