Larry's Tax Law

It Is Imperative That S Corporations And Their Shareholders Keep Track Of Stock And Debt Basis

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S corporations and their shareholders must keep track of stock and debt basis. Failure to do so can lead to disastrous results. *Nathel v. Commissioner*, 105 AFTR 2d 2010-2699 (2d Cir 2010), illustrates this point.

In *Nathel*, the government and the taxpayer stipulated to the facts. Two brothers and a friend formed three separate S corporations to operate food distribution businesses in New York, Florida and California. All three shareholders made initial capital contributions to the corporations. The brothers also made loans to two of the corporations.

In 2001, one corporation was liquidated. In a reorganization of sorts, the friend ended up owning 100% of the second corporation and the two brothers ended up equally owning the third corporation.

In late 2000, before the reorganization, the brothers made loans to the corporations totaling around $1.3 million. In 2001, they made capital contributions totaling approximately $1.4 million. Also, in 2001, they received loan repayments combined in excess of $1.6 million.

Immediately before the repayment of the loans, the brothers had zero basis in their stock and only nominal basis in the loans. **Ouch!** To avoid the ordinary income tax hit on the delta between the $1.6 million in loan repayments and their nominal loan basis, the brothers, with the likely help of their handy dandy tax advisor, asserted the $1.4 million in capital contributions was really tax-exempt income to the corporation, excludable under IRC Section 118(a), but which, under IRC Section 1367(b)(2)(B), increased their loan basis. Therefore, the ordinary income tax hit on the loan repayments was nominal.

The Nathel brothers were correct about one point – – under IRC Sections 1366 and 1367, if the corporation had income, including tax-exempt income, such would restore debt basis to the extent of their share of that income. The Service pointed out to the Nathel brothers, however, that they were wrong about the most important point: capital contributions, in accordance with IRC Section 118, are not income to the recipient corporation. So, since the corporation had no income, there was no loan basis restoration. The additional capital contributions did, however, increase their stock basis, which may be of help to the Nathel brothers down the road. Additional stock basis, however, was of no help to the Nathel brothers as it did not reduce

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the tax burden resulting from the loan repayment.

- The taxpayers lose the debate;
- The IRS issues a 90-day letter; and
- The Nathel brothers are off to Tax Court.

The Nathel brothers, of course, lose again! Rather than stay down for the count, they proceed forward to the Second Circuit Court of Appeals, where they lose a third time.

There are two morals to this story:

- Capital contributions are not income to the recipient corporation for purposes of IRC Sections 1366 and 1367; and
- Shareholders of S corporations need to keep track of stock and debt basis to avoid the unpleasant tax news the Nathel brothers received in this case.

In a recent GAO report that looked at tax years 2006 through 2008, the government found that losses deducted by S corporation shareholders that exceeded basis limitations totaled around $10,000,000, or amounted to about $21,600 per shareholder/taxpayer. The GAO concluded that this non-compliance is the consequence of the actions of the shareholder, not the corporation. In other words, it is the shareholders', not the corporation's, duty to track and compute stock basis. Don't be surprised, however, if Congress does not amend the law, requiring S corporations to compute each shareholder's basis and include it on the IRS Form K-1 each year. Partnerships already have this duty in that they have to report the partner's beginning and ending capital account balances on the IRS Form K?1 each year.

S corporations and their shareholders must track both stock and debt basis. It is that simple.

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