Impact of S Corporation Debt on Shareholder's Basis

Summary

S corporation shareholders generally increase their basis in the business by making loans to the S corporation or by paying S corporation debt, but not by merely personally guaranteeing loans made to the S corporation by third parties.

Related Information

Life Insurance in S Corporations (Including LLCs Taxed as S Corporations).

In a recent decision, the United States Tax Court addressed the impact of S corporation debt on a shareholder's basis. In *Montgomery vs. Commissioner*,[1] Patrick and Patricia Montgomery had two businesses. One was an S corporation they had taken over from Patrick's father in which they were shareholders. The S corporation's business involved engineering. Because conflict of interest rules preclude the S corporation from performing construction work and engineering work on the same projects, the owners created an LLC (taxed as a partnership) to perform the construction work. Patricia Montgomery was a 40% member of the LLC.

In 2006, the S corporation borrowed $1 million from Sun Trust Bank. Like many small business owners, the Montgomery's personally guaranteed the debt. The year the LLC was formed, 2007, was not a good year for either of the Montgomery's businesses, with both incurring substantial losses. Patrick loaned an additional $105,000 to the S corporation. In 2008, the S corporation defaulted on the $1 million debt, and Sun Trust tried to collect from the Montgomerys because they guaranteed the debt. They too defaulted, and in 2009 a judgment was issued against them for $425,169.

The primary issue involved Montgomery's position that the $425,169 debt carried back to 2007 and increased their basis for that year. The Code limits S corporation shareholder losses to the shareholder's "basis in stock and debt."[2] Losses disallowed under this limitation in the year of the loss may be carried forward indefinitely,[3] but remain limited to the shareholder's basis in the year of the loss. Having an increased basis in 2007 presumably would have allowed the Montgomerys to carry forward those losses to future years.

The Court noted that the $105,000 in loans made by Patrick Montgomery to the S corporation did increase the couple's basis in 2007, but explained that becoming liable as a guarantor on

[1] T.C. Memo 2013-151.
[2] § 1366(d)(1).
[3] § 1366(d)(2)(A).

S corporation debt does not trigger an increase in basis. The court stated that it is only after the guarantor makes a payment on the obligation that basis in the stock is increased.

The Montgomery's position was not entirely without support. In a 1982 Tax Court case,[4] shareholders of an S corporation gave a bank a personal note in the amount of an S corporation's debt and the bank cancelled the debt of the S corporation. There, the Tax Court found that because the shareholders had become "subrogated" to the S corporation's debt, their basis was increased. The court made a distinction between a shareholder merely being a guarantor (no basis increase) and the shareholder transferring the debt to themselves, taking over the liability as a primary obligor (basis increase). The *Montgomery* court found that this earlier case was not analogous to the case at hand because the S corporation here never became indebted to the Montgomerys.

The *Montgomery* court also quoted an even earlier ruling[5] to the effect that "it is the payment by the guarantor of the guaranteed obligation that gives rise to indebtedness on the part of the debtor [S corporation] to the guarantor [shareholder]. The mere fact that the debtor defaults and thereby renders the guarantor liable is not sufficient."

Because the Montgomerys did not make any payment on the $425,169 judgment against them, and the S corporation was never relieved of its liability, they did not acquire any additional basis in the S corporation.

Conclusion

This case makes it clear that once an S corporation becomes indebted to a shareholder, either by being discharged from a debt (because the shareholder took over the debt personally) or by the shareholder actually making payment of the debt, the shareholder receives an increased basis. However, merely guaranteeing a loan does not give rise to an increase in basis. The distinction is important, because a taxpayer cannot take net operating losses in excess of his or her basis in the S corporation.

4 *Gilday v. Comm'r*, TC Memo 1982-242.
5 *Underwood v. Comm'r*, 63 TC 468 (1975).

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