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S Corporation Corner

Shareholder Guaranty Payments and Loans—Stuck Between Bad Debt Deduction and Capital Contribution

By Robert C. Walthall

A shareholder who serves as a guarantor, endorser or indemnitor of a corporate debt obligation must consider the tax consequences of a default by the corporation and payment on such corporate obligation. Such taxpayers face a number of challenging tax issues including the following:

(1) Does the payment create a corporate debt or a contribution to capital by the shareholder;
(2) If such payment constitutes a corporate debt obligation, is it a business or nonbusiness debt obligation;
(3) If such payment constitutes a corporate debt obligation, if and when does it become completely or partially worthless; and
(4) If such payment is a contribution to capital, and completely or partially worthless, is there a capital loss deduction for the shareholder?

A taxpayer who has advanced money to a corporation and subsequently holds an uncollectible or worthless corporate obligation faces similar tax issues.

This column is limited in scope to the above issues and will not address the final debt *versus* equity regulations issued under Code Sec. 385 and that are effective for investments issued on or after January 1, 2019.[1] Also, relevant to this discussion are the tax cases and new IRS regulations governing S corporation shareholder guarantees and shareholder basis. Code Sec. 1366(d)(1) provides that the amount of losses and deductions an S corporation shareholder may deduct in any tax year may not exceed the sum of the shareholder's adjusted basis in the stock of the S corporation plus the adjusted basis of "any indebtedness of the S corporation to the shareholder." Losses not allowed due to insufficient basis may be carried forward indefinitely under Code Sec. 1366(d)(2). Basis is increased where S corporation shareholders make a direct loan to an S corporation using their own funds or funds from which they are directly liable, including their borrowings from a related party, so long as a genuine indebtedness is created.[2] Basis is not established where shareholders are only contingently liable by way of their status as a co-borrower, co-maker,

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or guarantor on an S corporation's debt to a third party.[3] Reg. §1.1366–2(a)(2)(ii) specifically provides that shareholders do not establish basis in an S corporation by merely guaranteeing a loan of an S corporation or otherwise acting as a surety for the loan. Only when shareholders make a payment toward a genuine debt of the S corporation for which they have acted as a guarantor is their basis increased, and then only to the extent of that payment.

A shareholder who serves as a guarantor, endorser or indemnitor of a corporate debt obligation must consider the tax consequences of a default by the corporation and payment on such corporate obligation.

Three very recent cases involving a shareholder advance or guaranty payment well illustrate the importance of meticulous and contemporaneous documentation of the debtor–creditor relationship between the shareholder and the debtor corporation. In *J.M. Sensenig*,[4] the Third Circuit affirmed the Tax Court in its holding that transfers from a taxpayer to companies in which he had an equity interest represented equity investments, and not loans. Accordingly, the court upheld the disallowance of the taxpayer's deduction of the transfers as "wholly worthless" loans under Code Sec. 166(a)(1). The Tax Court concluded that the transfers were equity, not debt, and thus could not be deducted under Code Sec. 166. The Tax Court said there were three factors to consider: (1) The intent of the parties; (2) The form of the instrument; and (3) The objective economic reality of the transaction as it relates to the risk taken by investors. The Tax Court said the investment had little or no form. There was no loan agreement providing for repayment of the taxpayer's transfers; there was, in fact, no written agreement of any sort, and the taxpayer never made any form of demands for repayment. As to economic reality, the Tax Court said that the acid test of the economic reality of a purported debt is whether an unrelated outside party would have advanced funds under like circumstances—and that the taxpayer failed this test as well. The taxpayer in *K. Norgaard*[5] claimed a bad debt deduction under Code Sec. 166 for payment of her obligation as a guarantor of an SBA loan to the corporation in which she was the majority shareholder. The court found that there was no evidence of indebtedness for reimbursement of the guaranty payment (such as a note), no collateral or other security and no fixed repayment plan. Repayment, if it were to occur, was from the company's future earnings. The court noted that the economic reality for the transaction was that the repayment of the loan was in fact a form of capital contribution by the taxpayer to the corporation. There was no discussion of whether the taxpayer would be entitled to a capital loss for such capital investment in the insolvent corporation.

The taxpayer in *M.J. Burke*[6] advanced in excess of $11,000,000 to a corporation engaged in the scuba diving business. The taxpayer did not obtain formal loan documents from the corporation for any of these advances. Each time, the taxpayer advanced money, he did so without setting a time for repayment. He testified at trial that he did not expect to receive payment until the business was profitable and he would "be paid his share of the profits." In contrast, when the corporation obtained loans from third-party lenders over the years, the corporation signed formal written documents and paid the lenders back, according to schedule, with interest. The taxpayer, after realizing a substantial gain on an unrelated investment, started working with tax attorneys on documentation for his advances to the corporation. They focused on tax planning, and more specifically, "reviewing alternatives for creating a capital loss to offset capital gain." It was out of this tax planning process that three promissory notes from the corporation surfaced. The first note was a junior promissory note for $3,000,000; the second was a junior promissory note for $2,171,000; and the third was a senior promissory note for $6,000,000. At this point, the taxpayer's attorneys advised him that he was entitled to claim some losses. Accordingly, he claimed a short-term capital loss of nearly $800,000 and a long-term capital loss of more than $2,000,000 on his 2010 tax return. He then claimed additional short-term and long-term capital losses on his 2011 tax return. After examining the absence of the normal incidents of a loan-stated maturity date and interest rate—the court decided that without those aspects of a loan the advances looked more like capital contributions to the corporation. The court's conclusion was reinforced by the strong evidence of the old friendship of the taxpayer and his business partner in the corporation and the taxpayer's desire to help his old friend turn their old hobby into a new business—a practical partnership where the taxpayer contributed

money and his friend contributed his labor and expertise and both hoped to share in the profits.

General Rules for Shareholder Payment of Corporate Debt Obligation

Reg. §1.166–9 governs payments made by guarantors pursuant to agreements. The Regulations apply not only to guarantors but also endorsers, indemnitors and others secondarily liable on a debt obligation, all of which are referred to herein as "guarantors."[7] Payments by guarantors in satisfaction of their guarantee obligations are deductible as bad debts under Code Sec. 166 if: (1) the guarantee was entered into in the taxpayer's trade or business or a transaction for profit; (2) the taxpayer was legally obligated to make the payment (legal collection action is not a pre-requisite); (3) the guarantee was made before the debt became worthless; and (4) the guarantor receives reasonable consideration therefor.[8] A guarantee is deemed to be made before the debt is worthless if there is a reasonable expectation on the part of the guarantor, at the time the guarantee is made, that the guarantor will not be called upon to pay the debt without full reimbursement from the maker of the debt.[9] The requirement of "reasonable consideration" is not limited to cash or property, but includes guarantees made in accordance with normal business practices or for a good business purpose. However, direct consideration, in cash or property, is required for a guarantee of a family member's debt.[10] A shareholder/guarantor of corporate debt does not receive bad debt treatment if, based on the facts and circumstances at the time the guarantee was entered into, the payment was actually a capital contribution by the shareholder.[11]

Payments on guarantees made in the course of a trade or business that are worthless are treated as business bad debts and are deductible from ordinary income; similar payments made pursuant to guarantees in transactions for profit, but not in a trade or business, are treated as nonbusiness bad debts and are deductible as short-term capital losses.[12] Guarantee payments unrelated to the guarantor's trade or business or a transaction for profit are nondeductible. In general, qualifying payments made in satisfaction of guarantee obligations are deductible in the year made; however, if the guarantee agreement gives the guarantor a right of subrogation against the debtor, payments are not deductible until the right of subrogation becomes worthless.[13]

There may be a situation when a shareholder will make payments of other types of obligations or expenses on behalf of a corporation and will want to deduct the payments as a current business expense. Such payments by a shareholder deemed necessary to preserve an ongoing business relationship may include payments to creditors, suppliers, employees and the like. Under Code Sec. 162(a), expenses paid by a taxpayer on behalf of another person are nondeductible unless the expenses represent an ordinary and necessary cost of the taxpayer's trade or business.[14] The tax treatment of these types of payments are discussed further at the end of this column.

If the guaranty payment is in substance a contribution to capital, the payment would be added to the shareholder's stock basis. However, if the guarantor's claim against the corporate debtor for reimbursement of payment made on a guarantee is worthless, the corporate equity also should be worthless and would generally not affect the timing of the deduction. A worthless stock loss is treated as arising from a sale or exchange of the stock on the last day of the taxable year during which the stock becomes worthless.[15] A nonbusiness bad debt deduction is a short-term capital loss. Where a guarantee payment is treated as a contribution to capital and the right for reimbursement does not become worthless until the following tax year, the loss will be a long-term capital loss. In the case of a guarantee payment treated as a contribution to capital where the claim becomes worthless in the tax year in which the payment is made, the holding period for the "shares" attributable to the payment should begin on the date of the payment and have a tax basis equal to the payment, if the guarantor has properly claimed the worthless stock deduction in a prior year. Even if the stock has not become worthless in a prior year, it seems reasonable to treat the guarantor as having acquired a separate block of stock with a basis equal to the payment, but an argument can be made that he has merely acquired additional basis in his existing shares.

A Business or Nonbusiness Bad Debt or a Contribution to Capital

The line between a business or nonbusiness bad debt deduction on the one hand and a capital contribution to the corporation on the other is often difficult to determine. In the following four cases, the taxpayer

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claimed a business bad debt deduction for payment on the guarantee of the S corporation loan and wound up with a nonbusiness bad debt deduction. In *E.V. Miller*,[16] the Tax Court held that the dominant motivation for the shareholder's guarantee payments of his corporation's obligations was to minimize the shareholder's liability in the corporation. Thus, the shareholder had a nonbusiness bad debt. The court rejected the shareholder's contention that his dominate motive was to protect his individual legal practice. In *L.A. Forest*,[17] the IRS argued that the taxpayer–shareholder payment on a guaranty of a corporation loan was a capital contribution because the creditor looked to the taxpayer, rather than to the corporate assets, for repayment of the loan. However, the court held that the substance of the taxpayer's guarantee was debt not equity because the loan was secured by a purchase-money security interest in corporate assets that were adequate for the loan. In *J.S. Payne*,[18] the Tax Court held that the taxpayer was entitled to a nonbusiness bad debt deduction for the amount equal to his guaranty of the corporation's loan. The taxpayer had guaranteed loans to a real estate development corporation, in which he held 50% of the stock. The taxpayer practiced law and did not engage in real estate development outside his 50% ownership interest in the corporation. In *W.J. Fleischaker*,[19] the court held that a doctor's payment on guarantees of loans made to the corporation he organized (with other investors) to operate a nursing home facility were nonbusiness bad debts. The taxpayer was not in the business of developing and promoting businesses. Rather, he intended to profit from his long-term stock ownership in the corporation.

Conversely, no bad debt deduction was allowable for any payment made by a taxpayer as guarantor of a corporate obligation where, on the basis of the facts and circumstances at the time the obligation was entered into, the payment was a capital contribution by the shareholder.[20] In *G. Peterson*, a shareholder and officer of a corporation was not entitled to a bad debt deduction for payments made on his guarantee of the corporation's line of credit because the payment was in substance a contribution to capital. The corporation was undercapitalized and there was no evidence of any shareholders investment in addition to the guarantee.

Completely or Partially Worthless Bad Debt

Code Sec. 166(a)(1) provides that there is allowed a deduction for any debt which becomes worthless during the year. There is no precise test for determining when worthlessness during a taxable year exists. In general, a debt is deemed to be worthless when its holder is justified in abandoning hope of recovery.[21] Under Reg. §1.166–2(a), a determination as to whether a debt is worthless, in whole or in part, at a particular time is to be determined by all pertinent evidence available from all the surrounding circumstances, including the value of the collateral, if any, securing the debt, and the financial conditions of the debtor. Many courts follow an objective standard based upon sound business judgment. The courts have stated that the creditor may strike a middle course between optimism and pessimism and determine debts to be worthless in the exercise of sound business judgment based upon as complete information as is readily obtainable.[22] The taxpayer must not only establish that the debt was worthless by the end of the year in which the deduction was claimed, but must also establish that it was not worthless at the end of the immediately preceding year. The determination of worthlessness continues to be a highly subjective determination, depending on the facts of the particular case. The cases involving factors similar to the debt in question must be reviewed before taking a reporting position, and the determination of worthlessness documented in order to carry the burden necessary to take the deduction. In general, the courts have accepted various conditions that establish the worthlessness of a particular debt. These acceptable conditions include: events of default; overall business climate; a debtor's earning capacity; serious financial hardship suffered by the debtor; and a decline in the debtor's business. A debtor's financial difficulties, by itself, does not establish worthlessness, as such financial condition may only be temporary, and its financial position may improve within a reasonable period of time.[23] Additionally, the fact that a debt is actually paid in the subsequent year does not bar the deduction in a prior year.[24]

Burden of Proving Worthlessness

The courts and the regulations place the burden of proving worthlessness on the taxpayer, and it must be met by proving objective facts such as those noted above.[25] All efforts by the taxpayer to collect a debt, including demands made, discussions had with the debtor and his reasons for not paying the debt should be documented by the taxpayer.

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Tax Consequences to the Debtor of Discharge of Indebtedness

A creditor's claim to a bad debt deduction does not change the duty of the obligor to pay such debt. Therefore, the claiming of the bad debt deduction does not necessarily have tax consequences to the debtor. However, the creditor's decision to claim the bad debt deduction may lead to significant tax consequences to the debtor. The debtor's release from the obligation to repay would generally constitute taxable income to the debtor.[26] This is true whether the release occurs as a result of formal action taken by the creditor or by operation of law or the expiration of the statute of limitations. As a general rule, the debtor will recognize ordinary income equal to the amount of the debt discharged over the amount of cash and the fair market value of any property paid to the creditor.

Shareholder Payment of Corporation Obligations or Expenses

Aside from shareholder guaranty payments, a shareholder may want to deduct other payments made on behalf of a corporation as a current business expense. In general, shareholders are not allowed to deduct expenditures made on behalf of their corporation.[27] The amount of such payment by the shareholder is treated as a contribution to capital and can generate a capital loss when the shareholder disposes of the stock.[28] An exception to this general rule exist if the taxpayer–shareholder pays the expenses of a business to protect or promote his own trade or business, including the reputation or standing of such business in which case the payment is an ordinary and necessary expense of that other business and is not merely the expense of the corporation.[29] In *D.T. Allen*,[30] the Seventh Circuit reversed the Tax Court and held that a major shareholder was allowed to deduct payment of the corporation's debt because it was made to protect the reputation and credit standing of the shareholder's sole proprietorship. In *M. Lutz*,[31] the Fifth Circuit held that payments of a corporation's expenses made to maintain the shareholder's credit and business license were deductible. No deduction is allowed if the payment is made to protect the shareholder's investment.[32]

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ENDNOTES

1. *See* T.D. 9790, 81 FR 72, 858 (Oct. 13, 2016), as corrected by 82 FR 8165 (Jan. 24, 2017).
2. *D.G. Oren*, 84 TCM 50, Dec. 54,811(M), TC Memo. 2002–172, *aff'd*, CA-8, 2004-1 USTC ¶50,165, 357 F3d 854, and *C.E. Yates*, 82 TCM 805, Dec. 54,523(M), TC Memo. 2001–280.
3. *D. Leavitt Est.,* 90 TC 206, Dec. 44,557 (1988), *aff'd*, CA-4, 89-1 USTC ¶9332, 875 F2d 420.
4. *J.M. Sensenig*, CA-3, 121 AFTR 2018-1 USTC ¶ 50,138 (2018).
5. *K. Norgaard*, DC-MA, 2018-1 USTC ¶ 50,169 (Feb. 22, 2018).
6. *M.J. Burke*, 115 TCM 1066, Dec. 61,123(M), TC Memo. 2018-18 (Feb. 21, 2018).
7. Reg. §1.166-9(a), (b).
8. Reg. §1.166-9(d), §1.166–9(e).
9. Reg. §1.166-9(d)(3).
10. Reg. §1.166-9(e)(1).
11. Reg. §1.166-9(c).
12. Reg. §1.166-9(a), §1.166–9(b).
13. Reg. §1.166-9(e)(2).
14. *See T.H. Welch v. Helvering,* SCt, 3 USTC ¶1164, 290 US 111, 54 SCt 8; *S.J. Ludwig*, 68 TCM 961, Dec. 50,183(M), TC Memo. 1994-518.
15. Reg. §1.165(g)(1).
16. *E.V. Miller*, 37 TCM 1264, Dec. 35,321(M), TC Memo. 1978-304.
17. *L.A. Forest*, 70 TCM 349, Dec. 50,820(M), TC Memo. 1995-377.
18. *J.S. Payne*, 82 TCM 477, Dec. 54,469(M), TC Memo. 1998-227.
19. *W.J. Fleischaker*, 78 TCM 1257, Dec. 53,681(M), TC Memo. 1999-427.
20. *G. Peterson*, 74 TCM 335, Dec. 52,209(M), TC Memo. 1997-377; *See also J.A. Titmas*, 69 TCM 2920, Dec. 50,699(M), TC Memo. 1995-267; *H.E. Slater*, 56 TCM 1135, Dec. 45,440(M), TC Memo. 1989-35; and *D.L. Atkinson*, 48 TCM 577, Dec. 41,362(M), TC Memo. 1984-378, where shareholder guaranty payments were the equivalent of contributions to capital.
21. *M.J. Cole*, CA-7, 89-1 USTC ¶9263, 871 F2d 64.
22. *Minneapolis, St. Paul & Sault Ste. Marie Railroad Company*, CtCls, 64-1 USTC ¶9213, 164 CtCls 226 (1964).
23. *Production Steel Inc.*, 39 TCM 77, Dec. 36,299(M), TC Memo. 1979-361; *Roth Steel Tube Co.*, CA-6, 80–1 USTC ¶9410, 620 F2d 1176.
24. *E.C. Olson,* 10 TC 458, Dec. 16,298 (1948).
25. *J.S. Randall,* CA-10, 2008-2 USTC ¶50,480, 535 F3d 1221; Reg. §1.166–3(a)(2)(iii).
26. *Kirby Lumber Co.*, SCt, 2 USTC ¶814, 284 US 1, 52 SCt 4.
27. *A.A. Low v. Nunan*, CA-2, 46-1 USTC ¶9208, 154 F2d 261, *aff'g* Dec. 14,098(M), 3 TCM 859 (1944); *D. Subhendu*, Dec. 52,899(M), 76 TCM 594, TC Memo. 1998-353.
28. *H.H. Kout*, Dec. 31,562(M), 31 TCM 1044, TC Memo. 1972-212; *B. Caudill*, Dec. 32,757(M), 33 TCM 1025, TC Memo. 1974-232.
29. *J.L. Lohrke*, 48 TC 679, Dec. 28,570; *M.S. Conley*, Dec. 34,757(M), 36 TCM 1644, TC Memo. 1977-406.
30. *D.T. Allen*, CA-7, 60–2 USTC ¶9759, 283 F2d 785, *rev'g* Dec. 23,875(M), 18 TCM 1101, TC Memo. 1959-227.
31. *M. Lutz*, CA-5, 60–2 USTC ¶9687, 282 F2d 614, *rev'g* Dec. 23,463(M), 18 TCM 152, TC Memo. 1959-32.
32. *R. Madden*, Dec. 37,196(M), 40 TCM 1103, TC Memo. 1980-350.

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