

Larry's Tax Law

Neither A Guaranty By A Shareholder Nor An Unpaid Judgment Against A Shareholder For The S Corporation's Debt Creates Basis

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Montgomery v. Commissioner, T.C. Memo. 2013-151 (June 17, 2013) illustrates what appeared to be the obvious – neither a guaranty of the corporation's debt by a shareholder nor an unpaid judgment against a shareholder for the S corporation's debt creates basis.

In *Montgomery*, the taxpayers, Patrick and Patricia Montgomery, claimed a net operating loss on their 2007 joint return, which they carried back to 2005 and 2006. In the calculation of their net operating loss, they included: losses UDI Underground, LLC ("UDI"), incurred in 2007 that were passed through to Patricia Montgomery as a 40% member; and losses Utility Design, Inc., an S corporation ("Utility Design"), incurred in 2007 that were passed through to Patrick and Patricia Montgomery as shareholders.

The IRS challenged the amount of the net operating loss for 2007 on two grounds:

- First, the IRS asserted Patricia Montgomery did not materially participate in UDI during 2007.

- Second, the IRS asserted portions of the losses from Utility Design were disallowed under Section 1366(d)(1).

- The IRS asserted Patricia Montgomery's share of the 2007 losses from UDI were losses from a passive activity. Specifically, the IRS argued Patricia Montgomery did not materially participate in UDI.

The Tax Court disagreed, holding Patricia Montgomery did materially participate in UDI. In 2007, Patricia Montgomery handled all of the office functions, managed payroll, prepared documents, met with members of the company and attended business meetings. Additionally,

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she continuously worked on company matters and daily discussed the company's business with Patrick Montgomery. The court ultimately concluded Patricia Montgomery participated in UDI for more than 500 hours during 2007 and her participation was regular, continuous, and substantial. Thus, Patricia Montgomery's UDI activity was a non-passive activity.

Next, the Tax Court considered whether the taxpayers' portion of the net operating loss attributable to Utility Design was limited by Section 1366(a). Section 1366(a) requires an S corporation shareholder, when calculating his or her taxable income for the year, to take into account his or her pro rata share of the S corporation's items of income, loss, deduction, or credit for the S corporation's tax year that ends in the tax year of the shareholder. However, the S corporation's loss taken into account by a shareholder cannot exceed the limitation amount calculated under Section 1366(d)(1), which is equal to the shareholder's adjusted basis in the S corporation stock increased by the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder.

The Tax Court concluded Patrick Montgomery's basis in the Utility Design stock was zero at the beginning of 2007. It then considered basis adjustments. In 2006 and 2007, Utility Design borrowed the following amounts: \$1 million from SunTrust Bank on August 25, 2006, (which was personally guaranteed by the taxpayers); \$60,000 from Patrick Montgomery on September 26, 2007; \$30,000 from Patrick Montgomery on October 5, 2007; and \$15,000 from Patrick Montgomery on November 13, 2007.

In 2008, Utility Design defaulted on the \$1 million loan. The bank proceeded to pursue claims against the taxpayers on the personal guarantees. The taxpayers failed to pay the debt under the guarantees, despite repeated demand and the filing of a lawsuit against them. Ultimately, in November 2009, a judgment was entered in favor of the bank against them for \$425,169.54. The taxpayers took the position that their basis in the Utility Design shares was increased by the amount of the judgment (i.e. \$425,169.54).

The IRS contended the judgment amount did not increase the taxpayers' stock basis. When an S corporation shareholder guarantees a loan of the corporation, no debt has been created between the S corporation and the shareholder. However, once the shareholder pays the bank pursuant to the guarantee, the S corporation becomes indebted to the shareholder and the shareholder obtains basis.

Accordingly, the court held that, because the taxpayers, Patrick and Patricia Montgomery, did not make any payments under the guarantee, their guarantee did not increase share basis. To put salt on the wound, the court upheld the Service's imposition of a Code Section 6651(a)(1) penalty against the taxpayers for late filing.

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The moral to this story is simple: You do not get basis merely by guaranteeing the corporation's debt. Also, unless you pay the debt, a judgment against you will not give you basis. Last, but certainly not least, failure to follow these clear rules could result in penalties.

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