



Maximizing the Tax Benefit of Loan Guarantees *– Plan Proactively for Potential Losses*



By:

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About the Author:

Shirley Fieber joined Kerkering Barberio in 1993 and was admitted as shareholder in 2002. She concentrates her practice in the areas of Construction Services, Individual and Business Tax Consulting and Real Estate Support Services. She has experience in Partnership and Limited Liability Company taxation and provides Cost Segregation Study services to businesses and investors.

As entrepreneurs, it's in our nature to be optimistic. We went into business with the idea of making a difference *and* making a profit. But sometimes circumstances beyond our control can throw a wrench into our expectations. The results are both emotional and financial – disappointment that things aren't going as we anticipated coupled with financial reversals.

With some advance planning you can maximize the tax benefits of losses that occur when you help rescue a business in which you are a shareholder.

Help!

A case in point is a client who called me recently with the following SOS. I'll call him Mike. *"Shirley. My closely held S corporation is losing money. The corporation has had to borrow more money to get us through. As the shareholder I had to guarantee the debt. If the corporation can't repay, it's up to me. But I've been told I can't deduct the losses on my tax return because I have no debt basis. What's going on? Please advise!"*

Understandably, Mike wants to be able to receive a tax benefit for the loan guarantee he has provided the corporation. The entity does not pay taxes. Rather, it passes the gains or losses to the shareholder where they are reported on the shareholder's tax return.

In order to deduct those losses the shareholder must have what's known as "basis" in the corporation. This can reside in stock, but in a business that's losing money, stock basis can be easily used up. The next place we look for basis is in debt – money loaned from the shareholder to the corporation. In order to achieve debt basis, the IRS requires a shareholder to loan funds directly to the corporation. This necessitates a careful structuring of the debt.

Economic Outlay

Shareholders need to understand that a loan from a third party (such as a bank) to the corporation does not provide debt basis to the shareholder even if the shareholder acts as guarantor. In order to be considered "debt basis" the loan must not be merely guaranteed by the shareholder; there must be an economic outlay by

the shareholder for the corporation. For example, if Mike guaranteed the debt and had to make payments on the note for several months, the IRS would consider the amount paid as debt basis. Mike had an economic outlay as a guarantor. As such Mike could deduct the losses on his tax return using that debt basis. But if all he did was guarantee the debt against his individual assets, there would be no debt basis.

Other Scenarios

There are other possible scenarios that could increase your chance of increasing debt basis. Let's say the corporation has borrowed \$100,000 from the bank and you, the shareholder, signed onto the loan. In order to realize debt basis, you would need to borrow \$100,000 from the bank, possibly using your stock as collateral, obtain the loan, then loan that sum to the corporation, possibly under the same terms. The corporation then pays off the bank. In such cases, it is important that the corporation does not make loan repayments directly to the third party, but to the shareholder as repayment on his note. Then the shareholder makes re-payments to his lender directly.

In some instances it is possible to simply substitute a new note for the existing bank note, thus providing "complete satisfaction" of the existing note. This has not always held up in court and I personally advise clients to obtain an entirely new note if possible. You'll want to talk with a tax advisor to identify the best strategy for you.

The bottom line is this – we tend to plan for income not for losses. But when reversals do occur, proactive planning can help ensure that you can benefit tax-wise from loans you make.

I would be happy to assist you with any of your questions. Please call (941-365-4617) or email me (sfieber@kgrp.com).

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