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Debt and Flow-Through Tax Entities

S corporations, partnerships, and limited liability companies taxed as partnerships continue to be popular entity choices for many business ventures. When making choice of entity decisions between those flow-through entity options, one of the most important considerations is the manner in which entity level debt is treated for purposes of computing the tax basis in the ownership interest of the owners. Poor structuring choices with regard to entity level debt can result in a number of undesirable income tax consequences.

Basis calculations affect business owners in such fundamental contexts as determining the gain or loss on the sale of ownership interests, determining the amount of cash that can be distributed from the business without incurring taxable gain, and determining the amount of flow-through losses that may be available to the business owners to deduct against other sources of income.

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In partnership entities, and entities taxed as partnerships, such as many limited liability companies, an increase in entity level debt allocated to a partner is treated as a contribution of money, thereby increasing the partner's basis in his partnership interest. This explains, in part, why entities taxed as partnerships are the usual choice for highly leveraged business activities such as mortgaged real estate holdings. The manner in which entity level debt is allocated among the partners depends on who, if anyone, bears the ultimate economic risk of loss with respect to such debt.

For S corporations, entity level debt will generally not increase the basis of S corporation stock. One important exception to that rule, however, is that debt that is owed directly by the S corporation to the shareholder will increase the shareholder's basis in his stock, but only if such debt meets the requirement that such debt is "bona fide" debt. Care must, therefore, be taken with regard to the documentation of the debt owed to the shareholder. Mere guaranties of entity level debt by the shareholder will not be treated as bona fide debt owed to the shareholder. Similarly "back to back" arrangements whereby the shareholder borrows money from a third party and lends the money to the S corporation must be carefully designed to accomplish the desired basis results.

A careful review should be conducted to determine the tax effect on the owners of any entity level borrowing by an entity that is a flow-through entity for tax purposes.

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