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Shareholder Loans and Basis in S Corporations

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S corporations are sometimes analogized to partnerships (as when defining an S corporation as offering partnership-like tax treatment). The differences are probably at least as significant to the tax practitioner as are the similarities, however. Not least of those differences is in the treatment of entity debt vis-a-vis partner/shareholder tax basis for purposes of deducting losses.

Partnership Debt Rules

In one sense, the partnership has no debt. The tax law adopts the fiction that the partnership debt is the debt of the partners. Section 752 does that by providing that any increase in a partner's share of the partnership liabilities "or any increase in a partner's individual liabilities by reason of the assumption of partnership liabilities" is to be considered as so much cash contributed by the partner to the partnership. Any decrease, by the same token, is treated as so much cash distributed to the partner. Regulations under section 752 deal with the problems of nonrecourse partnership debt.

The S corporation has no equivalent fiction. It does have its own fiction, however, also created by statute. For the S corporation, that statute is section 1366(d), which provides that losses taken into account by a shareholder for any year cannot exceed the sum of the shareholder's basis in his or her stock plus "the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder." In turn, section 1367(b)(2) provides that if the losses and other deduction items exceed the amount needed to reduce the shareholder's basis to zero, that excess is to be applied to reduce the "shareholder's basis in any indebtedness of the corporation to the shareholder." When profits are realized, that indebtedness basis is first restored before the stock basis is increased. From that simple, straightforward phrase -- "any indebtedness of the S corporation to the shareholder" -- have come, however, dozens of decided tax cases.

'An Aroma of Alchemist's Brew'

An early S corporation case on this point, William H. Perry, et ux. v. Commissioner, 54 T.C. 1293 (1970), tested the proposition that a shareholder could issue demand notes to the S corporation in exchange for the corporation's long-term notes in the same amount and thereby increase the "shareholder's basis in . . . indebtedness of the corporation to the shareholder." The notes given to the corporation by the shareholder were carried as current assets on the corporate financial statements, while the notes given to the shareholder by the corporation were carried as long-term liabilities. Given the cash-poor status of the corporation, that at least improved the corporate current ratio and working capital (the ratio of current assets to current liabilities and the excess of current assets over current liabilities, respectively). The shareholder was also cash poor, so his accountant viewed the note swap as the only means by which corporate indebtedness to the shareholder could be created in an amount sufficient to allow the shareholder to obtain a tax benefit from the corporate loss.

The IRS concluded that the note swap wouldn't work. Tax Court Judge Leo H. Irwin agreed with the IRS and said that:

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> Viewed from our vantage point, the facts of this case yield an aroma of alchemist's brew. Cf. Knetsch v. United States, 364 U.S. 361 (1960). As we see matters, the transactions in this case amounted to little more than the posting of offsetting book entries, accompanied by the drafting of illusory instruments in commemoration thereof. Whether, in fact, petitioner's notes could, at some future time, have been enforced by Cardinal is, to our way of thinking, irrelevant. What is relevant is that in pure, pragmatic terms the exchanges of notes which generated Cardinal's long-term "indebtedness" left petitioner economically unimpaired, both actually and constructively.

Bank Loans and Pledged Assets

If Perry was left "economically unimpaired" by his note swap with his S corporation, would the result be any different when the shareholder guaranteed a third-party loan to the corporation and both posted S corporation stock as collateral for that loan and surrendered control of the corporation to the lender? That was the question posed to Tax Court Judge Diane L. Kroupa in William H. Maloof v. Commissioner, T.C. Memo. 2005-75, Doc 2005-7118, 2005 TNT 66-13. Although Tax Court precedent was against him, the taxpayer implied that whatever the prior Tax Court decisions may have indicated was irrelevant in the Eleventh Circuit, whose court of appeals would have jurisdiction over any appeal of the Tax Court's decision. In Selfe v. United States, 778 F.2d 769 (11th Cir. 1985), while reversing a district court's summary judgment for the government and remanding for trial on the facts, the Eleventh Circuit appeals court had commented in a footnote that:

> For example, a guarantor who has pledged stock to secure a loan has experienced an economic outlay to the extent that that pledged stock is not available as collateral for other investments. The guarantor in this example has lost the time value or use of its collateral.

Judge Kroupa summarized Selfe as holding that "a shareholder does not, in all circumstances, have to 'absolve' a corporation's debt to increase basis." She did not hold that Selfe was wrong; rather, she distinguished the facts. In Selfe the facts indicated that the bank might have looked primarily to the shareholder for repayment and that was the reason the collateral was required. In Maloof, said Judge Kroupa, the facts "indicate the bank looked primarily to the S corporation for repayment, not petitioner." Thus, the rule of Golsen v. Commissioner, 54 T.C. 742 (1970), requiring the Tax Court to follow the law of the circuit, had no applicability.

Maloof also had emphasized that he lost "control" of the corporation to the bank as the result of the loan he guaranteed. But he submitted no evidence to substantiate that loss, neither as to its existence nor as to how it would be valued. Even if there had been a "transitory loss of control," added Judge Kroupa in deciding against the taxpayer, "no basis-increasing event occurred. Petitioner remained at all times the owner of his shares."

'Actual Economic Outlay' and 'At Risk'

The Oren family owned three S corporations. Dart Transit provided trucking services using independent contractor drivers who leased or owned their own tractors; Highway Sales leased tractors to some of those drivers on lease-to-purchase contracts; and Highway Leasing leased trailers to Dart Transit. Because of accelerated depreciation deductions, Highway Sales and Highway Leasing had significant tax losses during 1993, 1994, and 1995, while Dart Transit had taxable income. That normally would not present a tax problem –- unless the Orens lacked

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sufficient tax basis to use the losses from Highway Sales and Highway Leasing to offset the Dart Transit profit. But they did.

The solution adopted on the recommendation of the Orens' personal financial advisers was a series of back-to-back loans. Each was a round-robin that started with Dart Transit making a loan to the Orens. The Orens then made loans to Highway Sales and Highway Leasing, thus increasing their tax basis and enabling the losses of those corporations to be used. In turn, Highway Sales and Highway Leasing "on the same day or within a few days" loaned the amounts it had received from the Orens to Dart Transit. Those transactions aggregated $15 million. All of the loans were represented by notes, and the terms of all of the notes were identical.

The IRS was not impressed. It disallowed the losses due to the basis increases claimed by the Orens, as well as the interest expense deductions that had been claimed. In Donald G. Oren, et ux. v. Commissioner, T.C. Memo. 2002-172, Doc 2002-16957, 2002 TNT 140-79, Tax Court Judge Robert P. Ruwe agreed with the IRS. The Orens, he concluded, had not made the "actual economic outlay" necessary under section 1366(d). He added that even if the loans had properly increased the Orens' tax basis, they still would not have been entitled to use the losses because the "loans" did not represent amounts "at risk" under section 465. Why the conclusion that the Orens' loans were not at risk under section 465? Judge Ruwe explained that "after examining all the facts and circumstances, we cannot conclude that there was a realistic possibility that Mr. Oren would be required to repay the Dart loan with his own personal resources."

In Oren v. Commissioner, No. 03-1448, Doc 2004-2967, 2004 TNT 30-14 (8th Cir. 2004), Circuit Judge Roger L. Wollman agreed with Judge Ruwe. "In determining whether a loan is an investment," he explained, the Eighth Circuit has "adopted the Tax Court's formulation of the 'actual economic outlay' doctrine, which states that, for basis to increase, a loan from a shareholder to an S corporation must be an actual economic outlay of money by the shareholders." That means the shareholder's own funds must be at risk.

Substance Over Form

Taxpayers have obviously not done well on the issue of shareholder loans, in large part because of bad facts. The bad facts are often the result of planning that relies on form and appears to create a shareholder loan although the substance involves no economic outlay. In Dennis E. Bolding v. Commissioner, 117 F.3d 270, Doc 97-21380, 97 TNT 140-8 (5th Cir. 1997), the taxpayer also faced bad facts, but those involved bad form rather than bad substance. They were bad enough, in any event, for the Tax Court, in T.C. Memo. 1995-326, Doc 95-7125, 95 TNT 142-14, to have found that the bank loan in question gave Bolding no basis.

What happened was that Bolding, who had been breeding and selling cattle in Texas since the late 1970s, formed Three Forks Land & Cattle Corp. in 1983, made an S election, and before 1990 had loaned approximately $500,000 to Three Forks. Operating losses had apparently reduced Bolding's tax basis in those loans to zero. In 1990 that $500,000 was contributed to the capital of the corporation. Also in 1990 Bolding sought a $250,000 line of credit from a bank in Lometa, Texas. He submitted a personal financial statement and a proposed operating statement showing the planned use of the funds. No financial information about Three Forks was asked for or submitted.

The line-of-credit paperwork, including the promissory note that Bolding signed, named "Dennis E. Bolding d/b/a Three Forks Land & Cattle

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Co." as the maker-borrower. A security agreement was signed the same way, while the UCC-1 statement was signed only by "Dennis E. Bolding." Nothing was ever signed by anyone on behalf of the corporation, but the funds were disbursed directly from the bank to Three Forks' corporate account and were used by Three Forks to purchase cattle. Although the tax year involved was 1990, the appeals court noted that when the line of credit ultimately went into default in 1994, the bank sued Bolding, not Three Forks.

The IRS rejected Bolding's contention that he had borrowed the $250,000 from the bank and then loaned it to Three Forks. The Tax Court agreed with Bolding that he, rather than Three Forks, had borrowed from the bank, but ultimately held for the IRS on the grounds that Bolding had failed to establish how much actually went to the corporation. On appeal, the IRS argued first that the appeals court should disregard the paperwork and "understand the loan for what it really was -– a loan from the Bank to Three Forks." Circuit Judge Will L. Garwood rejected that, concluding that "the Tax Court did not clearly err in finding that the $250,000 line of credit was a loan from the Bank to Taxpayer individually."

But that, of course, didn't end the matter. Judge Garwood explained that "we must next consider whether the Tax Court erred in finding that Taxpayer failed to prove that he advanced any proceeds of the $250,000 loan to Three Forks." On that, Judge Garwood reversed the Tax Court:

> The Tax Court's finding on this point is clearly erroneous. The court mistakenly overlooked the parties' stipulation of facts, which expressly provided that all of the proceeds from the $250,000 line of credit were deposited into Three Forks' corporate account. Further, the Commissioner concedes that if we were to find that the $250,000 line of credit was extended to Taxpayer individually (which we do), then we must necessarily find that Taxpayer was entitled to correspondingly increase his Three Forks basis, as all of the loan proceeds were deposited into Three Forks' account. In sum, because the Bank loan was to taxpayer alone, and he caused all of the proceeds of the loan to be deposited into Three Forks' corporate account as a loan by him to Three Forks, the Tax Court should have concluded that Taxpayer was entitled to his full deductions. The court's failure to do so was clear error.

Conclusion

S corporation shareholders in need of basis to deduct losses should seriously consider either:

- contributing assets with sufficient tax basis to the corporation; or
- borrowing the money needed and making a contribution to capital or a loan.

The tax reality is that shareholders in S corporations that have never been C corporations face no more tax consequences when withdrawing equity from the corporation than when repaying debt. Thus, in the interests of keeping matters simple, we prefer capital contributions rather than loans unless there are nontax reasons -- such as potential corporate insolvency or unwillingness of some shareholders to participate pro rata in what is being done -- that might make a loan position more desirable than a shareholder position.

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In any event, the type of meaningless paper swap involved in Perry is a nonstarter. A practitioner would be hard-pressed to sign a return taking losses on that basis, even with full disclosure, because it likely would be deemed a frivolous position. Selfe, on the other hand, holds out some hope for the situation in which the money goes from a third party directly to the S corporation but the shareholder is, in economic reality, the borrower, as in Bolding. Lenders seem to like those arrangements. From a tax planning perspective, however, the client should recognize that direct money transfers from third parties to the S corporation are much more likely to be challenged -– and the outcome of those challenges is uncertain, as witness the Bolding loss in the Tax Court, while the cost of tax controversy can be substantial. Better that the shareholders create a clear paper trail showing that they borrowed the money personally and then contributed or loaned it to the S corporation. Most lenders will go that route if they would have gone the other, all other things, including collateral pledged, being the same.

Finally, there is the Oren situation. When multiple S corporations have substantially identical ownership, the problem of using profits in one to offset losses in another can be handled at the S corporation level by contributing 100 percent of the stock of the additional S corporations to one S corporation and making qualified S corporation subsidiary elections. When that has not been done, it is the path of least resistance to transfer funds from the entity that has or can get the cash to the entity that needs it. Oren illustrates that it is difficult to document those transfers in such a way as to give a shareholder tax basis in the loss entity. The tax practitioner should try to educate the client to resist the direct transfer temptation. Especially when shareholder basis is being sought to support losses, it is far better to take a cash distribution from one entity and then contribute or loan those amounts to the loss entity for which basis is needed.

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