

# Shareholder Basis in the S Corporation: Debt Guarantees and Loans from Commonly Controlled Entities

By James A. Fellows

James Fellows explores some of the recent debt-basis controversy surrounding S corporations. In particular, he looks at the continuing saga of debt guarantees by a shareholder, as well as loans to an S corporation from other entities controlled by the same S corporation shareholder.

## Introduction

Code Sec. 1366(a)(1) allows a shareholder of an S corporation to deduct in his personal income tax return any losses passed through to him from an S corporation. However, Code Sec. 1366(d)(1) limits the amount of the losses currently deductible to the shareholder's tax basis in the S corporation, defined as this adjusted basis of the stock in the corporation plus the adjusted basis of any indebtedness of the corporation to the shareholder. Any loss not currently deductible is suspended under Code Sec. 1366(d)(2) and can be carried forward indefinitely until the shareholder obtains additional basis in the S corporation.

There is little controversy surrounding the shareholder's adjusted basis in his stock, *i.e.*, his stock basis. Either he has made a capital contribution to the corporation or he has not. The funds to purchase the stock can even come from borrowed funds. This was recently affirmed once again in the *Gleason* decision by the U.S. Tax Court.<sup>1</sup> In that case, the shareholder borrowed over \$6 million from a bank to purchase

the stock in two new S corporations. The IRS had questioned whether the shareholder was actually the true debtor on the loan rather than the corporation itself, but the facts of the case clearly indicated that the shareholder was the debtor, so he was allowed to deduct over \$6 million of losses due to this approved tax basis in his stock.

Although there can certainly be some "gray issues" on the matter of stock basis, the vast majority of litigation over shareholder basis relates to whether the shareholder has basis for loans made to the S corporation. Is a corporate debt to a third party, in economic substance, a debt of the corporation to the S corporation shareholder? If this connection can be made, then the shareholder obtains basis for the debt to support the deduction of S corporation losses passed through to him.

This article explores some of the recent debt basis controversy. In particular, it looks at the continuing saga of debt guarantees by a shareholder, as well as loans to an S corporation from other entities controlled by the same S corporation shareholder. Are these loans, in essence, advances from the shareholder himself to the S corporation? At the outset, it should be noted that shareholders will find it extremely difficult to argue successfully that debt guarantees and

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related party debt provide them with basis in the S corporation. Still, the courts are sometimes willing to look at the true economic substance of the transaction, and in a few instances shareholders have been accorded tax basis for such debt. These instances are rare, however, so shareholders and their counsel should not count on using similar methods to obtain basis in the S corporation.

## Debt Guarantees Redux

Despite continued rejection by the courts, shareholders continue to assert that their personal guarantee of S corporation debt to third parties should give them tax basis in the corporation. Shareholders have generally advanced two separate arguments here. On the one hand, they argue that the loan from the creditor to the S corporation is, in reality, a loan to the corporation from the shareholder, because the shareholder has guaranteed the debt, and/or perhaps signed as co-obligor on the loan, and/or personally granted the creditor a security interest in his own property. If the debt is in substance a debt to the shareholder, this would provide him basis in the S corporation through an increased loan basis. On the other hand, shareholders might argue, sometimes at the same time they make the first argument, that the guaranteed debt is, in reality, a loan from the creditor to the shareholder, followed by a contribution of capital by the shareholder to the corporation. This would increase the shareholder's stock basis. Regardless of the position taken, shareholders uniformly have been denied basis for such guarantees.

### The *Selfe* Distraction

The continuing litigation over debt guarantees by shareholders is undoubtedly inspired by the Eleventh Circuit's decision in *Selfe*.<sup>2</sup> To date, this is the only decision to grant any shareholder any tax basis in the S corporation for making a personal guarantee of corporate debt. But as subsequent courts have continually pointed out, *Selfe* was a unique and distinct set of facts and the decision established exceedingly narrow parameters for the shareholder. Unfortunately it opened a "Pandora's Box" of litigation.

The facts in the case involved a sole proprietor who incorporated her existing business as an S corporation. While conducting the business as a sole proprietorship, the owner had borrowed funds from a commercial bank in her own name and secured by property that she owned. When she incorporated the business she transferred the debt into the corporation so that the corporation became the primary obligor on the debt. The bank required that the shareholder personally guarantee the debt and to continue to secure the debt with her own property outside the corporation.

The Eleventh Circuit opined that, based on these facts, the bank was looking to the shareholder as the primary obligor on the note, foremost because the bank had lent the money to her personally to begin with, prior to the incorporation of her business. Indeed, the court heard testimony from a bank officer that this was the bank's view of the matter. Because the shareholder was, in substance, still the primary obligor on the note to the bank, the court held that the shareholder should be entitled to tax basis in her S corporation for the amount of the debt.

### The Economic Outlay Doctrine

Despite the success of the taxpayer in *Selfe*, the IRS and the courts have continually struck down repeated attempts by shareholders to transform debt guarantees or co-obligations as providing basis in the S corporation.<sup>3</sup> In rejecting these claims, the courts have established what has become known as "the economic outlay doctrine."<sup>4</sup> Under this judicial doctrine, shareholders are allowed no increase in basis (regardless of whether they are asserting an increase in loan basis or stock basis) until they actually make some type of investment or expenditure that, when fully consummated, leaves them poorer in a material sense.<sup>5</sup>

A mere personal guarantee does not do this. Nor, according to the courts, does being a co-obligor along with the S corporation, or even using the shareholder's own personally owned property to collateralize the loan. What is necessary to obtain basis in this situation is for the corporation to default on the loan so that the

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bank or other creditor now requires the shareholder to make good on the note. Even then, the shareholder receives no tax basis in the S corporation until he actually makes a payment to the bank to satisfy the loan. The mere default by the S corporation, with the shareholder now becoming the primary obligor, does not establish tax basis. To achieve any tax basis in the S corporation requires the shareholder to start paying down the loan to the bank.<sup>6</sup>

For example, assume that Sally Shareholder is the sole shareholder of an S corporation. She personally guarantees a \$100,000 loan made by a commercial bank to the corporation. The corporation defaults on the loan and the bank now looks to the personal guarantee of Sally for eventual payment. According to the economic outlay doctrine, there is no increase in Sally's tax basis in the corporation from this mere transfer of liability. Only when Sally begins to pay down the debt to the bank, when she is making an economic outlay, is there any increase in her basis in the S corporation.

For instance, if Sally pays off \$20,000 of the debt within the next few months, she has an increase of \$20,000 in her basis in the S corporation. One potential characterization of this payment would be that Sally made a capital contribution, increasing the basis of her stock, so the following journal entries on the corporate books would be made when this \$20,000 payment, and each subsequent payment, is made.

Note Payable—Bank	20,000
Capital Contribution	20,000

Under the economic outlay doctrine, the corporation should still continue to show the note payable to the bank on its books, with each subsequent payment by Sally charged against this balance with an equal increase in paid-in capital from Sally.<sup>7</sup>

Alternatively, Sally could be subrogated to the Bank's position with respect to each payment she makes, so that the increase in Sally's basis could be construed as a debt of the corporation to Sally, thereby resulting in the following journal entry:

Note Payable—Bank	20,000
Note Payable—Sally	20,000

Shareholders and their counsel may feel this delay of basis increase until actual payment on the note is made is really neither fair nor logical. After all, isn't Sally now "on the hook" for the entire \$100,000? Following the *Selfe* doctrine, doesn't the bank now look to Sally as the primary obligor

on the debt? These are good questions, but both the IRS, in Rev. Rul. 70-50, and the courts, in numerous decisions, have stated that there is no basis increase until actual payments on the note are made. The reasoning here is that although the shareholder is now making payments to the bank as guarantor, the corporation is still the formal debtor on the loan. As long as that is the legal situation, there is no basis increase to the shareholder until payments are made as guarantor.

### Note Substitution as Basis Creation

However, there is a solution to Sally's dilemma. Rev. Rul. 75-144 states that if the shareholder formally substitutes her own note to the bank in replacement of the corporation's note, relieving the corporation of all present and future liability to the bank, this will enable the shareholder to achieve full tax basis for the entire amount of the note.<sup>8</sup> Thus, if Sally follows this approach, she will have her basis increase of \$100,000 immediately, with the corporation recording the following entry on its books, assuming that Sally wishes to treat her basis increase as a capital contribution and thus an increase in her stock basis.

Note Payable – Bank	100,000
Capital Contribution	100,000

This procedure has been upheld in several court decisions, most recently by the Tax Court in its *Miller* decision.<sup>9</sup> The facts in this case involved a shareholder in an S corporation who had originally guaranteed a \$1 million debt of the S corporation to a commercial bank. The shareholder even used his personal residence as security for the loan. However, this mere guarantee was not sufficient to establish basis in the S corporation. In order to obtain tax basis for numerous and sundry losses from the corporation, the shareholder's tax advisor counseled him to arrange with the bank to have his own note substituted for that of the corporation. The bank agreed to do this, but only if the new note were guaranteed by the corporation. In other words, the shareholder and corporation just exchanged positions. On the corporate books the following journal entry was made:

Note Payable—Bank	1,000,000
Note Payable—Shareholder	1,000,000

The shareholder then deducted the losses on his individual income tax return. The IRS denied the loss deductions, arguing that the shareholder did not have

the sufficient basis in the S corporation. The IRS did not view the agreement with the bank as sufficient to make the shareholder the true debtor on the note, arguing that because the corporation now guaranteed the loan, it was in substance still the true debtor.

The court, however, cited Rev. Rul. 75-144 and its earlier decision in *Gilday* to grant the shareholder the basis increase.<sup>10</sup> In the court's view, as long as the note substitution completely eliminated the S corporation as primary obligor to the bank, the fact that the corporation guaranteed the debt was a moot point. The facts of the case clearly indicated that the note from the shareholder to the bank was a recourse debt, with the shareholder also continuing to secure the note with his personal residence and other personal assets. In the court's view, the shareholder was the primary obligor, in fact and in substance, and was allowed the basis increase and the corresponding loss for the corporate deductions passed through to him.

### **The *Maloof* Decision**

The current judicial doctrine on debt guarantees is thoroughly summarized in the recent decision of the Sixth Circuit in *Maloof*.<sup>11</sup> The shareholder in *Maloof* was the sole owner of several S corporations, all of which had been incurring losses. The corporations had borrowed \$4 million in total from a commercial bank. The shareholder was also the co-obligor on the loan, and pledged a \$1 million life insurance policy as collateral as well as pledging all of his shares of stock in the various S corporations. The shareholder used all \$4 million of the loan as tax basis for claiming deductions in his personal tax return. The IRS disallowed all of these deductions and the Tax Court agreed with the IRS. The taxpayer then appealed to the Sixth Circuit Court of Appeals.

In its decision, the appellate court affirmed the lower Tax Court decision denying the shareholder any basis for his personal guarantee of \$4 million corporate debt to the commercial bank. In its opinion, the Sixth Circuit cited a long litany of cases wherein the shareholder was denied tax basis for personally guaranteeing corporate debt. The fact that the shareholder co-signed on the note and placed personal property as collateral for the debt did not suffice to

give him basis. None of this constitutes the requisite "economic outlay" that is necessary to obtain basis in the S corporation. Only if the bank had called upon the shareholder to perform on this guarantee would basis be granted.

The court also rejected the shareholder's claim that he should have basis under the *Selfe* doctrine, *i.e.*, that the bank really considered the shareholder the primary obligor on the note. The court noted that the *Selfe* court established an extremely narrow set of facts in which a guarantee would constitute basis. Basically this would occur only under the conditions found in *Selfe*, wherein the shareholder had actually borrowed the funds personally before incorporating her business. The debt was then transferred into the

corporation as part of the corporate formation. Nothing of that sort was found from the fact pattern in *Maloof*. Indeed, it was clear from the facts of the case that the bank looked primarily to the corporation for repayment. After all, if the bank had looked

to the shareholder as the primary obligor, why did it not lend the money directly to the shareholder, with the funds being contributed or lent to the corporation by the shareholder? Such a revised debt structure would have achieved the same business purpose, but probably would have generated tax basis for the shareholder. The fact that this obvious solution to the problem was not undertaken substantiates the court's opinion that the bank did not look to the shareholder as the primary obligor on the note.

The *Maloof* decision states the obvious. Shareholder guarantees of debt do not constitute tax basis in the S corporation except under the extraordinarily narrow fact pattern described in *Selfe*. Only actual payments on the note, so-called "economic outlays," create tax basis. Alternatively, following Rev. Rul. 75-144, as affirmed in such cases as the recent *Miller* decision, a substitution of the shareholder's own note for that of the corporation may suffice to create tax basis.

Indeed, one can almost read the courts' frustration at taxpayers in some of the recent opinions, as taxpayers continue to litigate what the courts feel is a settled issue. Many S corporation shareholders and their counsel have gotten the message on the tax fallacy of such guarantees. However, perhaps because of this "lost cause" on debt guarantees, imaginative

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tax planning has now focused on another issue that is making its way through the judicial process, *viz.*, the S corporation borrowing funds from another entity controlled by the same shareholder. Is this, in substance, an advance to the S corporation from the controlling shareholder, providing the shareholder basis in the S corporation? As discussed below, it is difficult to achieve basis in the S corporation in this manner, but one must look at the economic substance of the transaction before reaching this conclusion.

## Loans from Related Party Entities: The Case of the Incorporated Pocketbooks

The related-party issue can be described by the following scenario. Suppose that Sally is the sole shareholder of two S corporations, A and B. Corporation A has substantial losses while Corporation B has been earning significant profits and has an ample cash position. Sally's tax basis in A is \$0.00, and she has \$100,000 of suspended losses from A. Sally's tax basis in B is \$250,000. Sally now directs B to loan \$100,000 to A. The loan is a direct advance from B to A, as shown by the journal entries on the books of the two corporations.

### Corporation A:

Cash	100,000	
Note Payable—B		100,000

### Corporation B:

Note Receivable—A	100,000	
Cash		100,000

Is there any likelihood that Sally can increase her tax basis in A because of this loan from B? The answer to this is no, not in the way the transaction is currently structured. The IRS and the courts have been steadfast in denying any basis increase for the shareholder in a scenario such as depicted above. The essence of their denial is in the form of the transaction. The books of both companies are treating the debt as being from one entity to another, without any intermediate shareholder involvement in the transfer of funds. Basically, if a shareholder controls two corporations, and the form of the transaction shows that the two corporations are the debtor and creditor, then that form must stand.<sup>12</sup> In other words, in the eyes of the courts, the transaction is to be given its tax effect in accord with what actually occurred and not in accord with what

might have occurred.<sup>13</sup> If a controlling shareholder arranges a transaction in a particular form, she cannot then argue that the form is not the true substance of the transaction. Given her control of the two entities, the form could have been easily adapted to match the economic substance, if indeed that substance was different than its form.

Assume, however, that Sally directs both Corporation A and B to record the following, even though the funds were advanced directly from B to A.

### Corporation A:

Cash	100,000	
Note Payable—Shareholder		100,000

### Corporation B:

Note Receivable—Shareholder	100,000	
Cash		100,000

Sally will now argue that the true substance of the transaction is that B loaned her the money, which she then loaned to A. Only the intermediate step of B actually dispensing funds to Sally, which she then loans to A, is missing. But is that formality, that intermediate step, really necessary? Are the foregoing journal entries now sufficient to provide Sally with tax basis in A? The answer to that question, like so many other questions of tax law, is that it depends on who you ask. In this case, the person you ask is the sitting judge hearing the case. The facts and circumstances surrounding the shareholder and her controlled corporations must be clearly determined.

The courts will look at these so-called “back-to-back” loans to determine their true economic substance. If the court feels that the facts support the argument that the shareholder has really advanced funds to the loss corporation, then the mere formality of the funds having to go through her hands is not important. Important in their decision will be the judicial doctrine of “incorporated pocketbooks.” Only if the creditor corporation is considered an “incorporated pocketbook” of the shareholder will tax basis be accorded her. Two decisions by the U.S. Tax Court provide the substance of this doctrine.

## The *Culnen* Decision

The essence of the judicial doctrine of the “incorporated pocketbook” is that the shareholder and her corporations are so intertwined that they are just one economic group, even if they are separate legal entities. It is therefore possible that one of the corporations is really just acting as an agent for the

shareholder by paying personal expenses and making other expenditures or disbursements on behalf of the shareholder. In *Culnen*, the taxpayer was the majority shareholder in an S corporation that was engaged in the restaurant business.<sup>14</sup> The S corporation was very unsuccessful, and passed through over \$1 million of losses to the shareholder before it filed for bankruptcy. The taxpayer was also the sole shareholder of a highly profitable C corporation engaged in the insurance business. On 46 different occasions during the years at issue, the C corporation loaned the S corporation over \$4 million. These were all direct transfers to the S corporation by the C corporation. On the books of the C corporation, the advances were treated as a loan to the shareholder. On the books of the S corporation, they were treated as loans from the shareholder. The journal entries for each advance can be summarized below.

**C Corporation:**

Note Receivable—Shareholder	XXX
Cash	XXX

**S Corporation:**

Cash	XXX
Note Payable—Shareholder	XXX

The C corporation also paid out nearly \$2 million for personal expenses of the shareholder that were not related to the S corporation. This made a grand total of over \$6 million of funds disbursed by the C corporation for personal use by the shareholder.

The IRS denied the shareholder the loss deductions from the S corporation. The IRS asserted that, notwithstanding the manner of recording the loans, the transactions really were direct transfers between the two corporations and should be treated as such under tax law, *i.e.*, as a receivable and a payable strictly between the two corporations. The form of the transaction should be honored.

The Tax Court, however, allowed the shareholder to deduct the losses. The court disagreed with the IRS contention that direct transfers between entities automatically precluded the shareholder from achieving tax basis for such transfers. Rather, said the court, each case must be determined on its facts. In the vast majority of those cases the facts will support the IRS.<sup>15</sup> But where the facts clearly show that the shareholder has historically used his controlled corporations to dispense large amounts of funds to pay personal expenses and make investments on the shareholder's behalf, and this policy has been practiced for a protracted period of time and in significant amounts,

the facts lean toward a decision for the shareholder obtaining basis. It is a case of "incorporated pocketbooks," *i.e.*, where the corporation ends and the individual begins is, in an economic sense, so vague that in essence the two are one and the same, *viz.*, one combined economic group.

In the court's view, this was the situation in *Culnen*. Significant amounts of personal expenses and investments were made on behalf of the shareholder by using the funds of the C corporation. There were over \$2 million in personal expenses paid by the C corporation on behalf of the shareholder that had nothing to do with loans to the S corporation. The economic substance of the transaction, in the eyes of the court, was that the C corporation was temporarily loaning money to the shareholder for various purposes, without going through the formality of advancing funds directly to him for use at his discretion. The C corporation was the proverbial "incorporated pocketbook" with the shareholder using the company accounts as if they were his personal checkbook.

The absence of a formal process, whereby the C corporation would loan money to the shareholder, who then would loan the money to the S corporation, was not fatal to the court's conclusion. The journal entries noted above, made by both corporations, were accepted as a reflection of reality by the court. The shareholder was able to deduct the losses passed through from the S corporation.

### The *Yates* Decision

In *Yates*, the Tax Court reached a similar decision under its "incorporated pocketbook" doctrine.<sup>16</sup> The fact pattern in *Yates* involved a taxpayer who was the sole shareholder in two S corporations, Corporation AD and Corporation FT. Corporation AD was a successful enterprise with large amounts of undistributed earnings in the corporate accumulated adjustment account (AAA). Corporation FT was generating at continual and significant losses. Over the years at issue, the shareholder had written over \$4 million of checks on the AD account, using the money for personal expenses unrelated to either AD or FT. In total, there were 522 such checks. These disbursements were accounted for as distributions from the corporate AAA to the shareholder, and constituted tax-free recovery of his stock basis.<sup>17</sup>

In addition to these checks for shareholder personal expenses, AD also transferred directly to FT over \$4.3 million to help it meet operating expenses. More than

half, \$2.78 million, was recorded on the books of AD as a distribution to the shareholder out of AAA, while the remainder, \$1.56 million, was recorded as a loan from AD to the shareholder. In all cases, the amounts were then recorded on the books of FT as either a contribution to capital from the shareholder or a note payable to the shareholder. The journal entries of the two corporations can be summarized as follows:

**Corporation AD:**

AAA	XXX
Cash	XXX
or	
Note Receivable—Shareholder	XXX
Cash	XXX

**Corporation FT:**

Cash	XXX
Contributed Capital	XXX
or	
Cash	XXX
Note Payable—Shareholder	XXX

Using these direct advances for tax basis in FT, the shareholder deducted significant losses passed through from FT on his individual income tax return. The IRS denied these loss deductions, arguing that the direct transfers from AD to FT did not establish basis for the shareholder. The Tax Court, citing its earlier decision in *Culnen*, disagreed with the IRS and allowed the loss deductions for the shareholder.

The court looked at the long history of the shareholder’s personal use of the corporate funds of AD, and found as credible several witnesses who were either bookkeepers or CPAs for the two corporations, all of whom testified that the taxpayer had historically used AD an “incorporated pocketbook.” Once again, the court looked at the economic substance of the direct transfers, and, as in *Culnen*, it found that the substance of the transaction matched its form. The journal entries on the books of both corporations summarized succinctly the underlying economics of the transactions. The shareholder was allowed the requisite basis for deducting the losses passed through from FT.

**Loans from Related-Party Entities: Recent Judicial History**

The Tax Court decisions in *Culnen* and *Yates* have left a narrow opening to taxpayers who wish to assert that debt to an S corporation from a related-party entity constitutes shareholder basis in the S

corporation. But it is a narrow opening, at best. As both decisions conclude, the taxpayer must prove to the court that the related-party entity that is serving as creditor must be an “incorporated pocketbook” of the taxpayer, merely serving as a *de facto* agent for the taxpayer. Two recent decisions by the Tax Court point out to taxpayers that obtaining tax basis for related-party debt is a difficult process.

**The Kaplan Decision: The Fact Pattern**

In *Kaplan*, the taxpayer was the sole shareholder of several S corporations that were engaged in real estate development.<sup>18</sup> One of these corporations (“Loss Corporation”) sustained heavy losses during the years at issue. In order to create tax basis in the loss corporation, the shareholder took the following steps.

First, he personally borrowed \$800,000 from a commercial bank. The loan matured in one month, payable in full. The loan was collateralized by accounts at the same bank of two other S corporations owned by the shareholder. For the sake of simplicity, these two corporations are designated here as one entity, Profit Corporation. These two corporate accounts were opened at the time of the loan solely for the purposes of facilitating the loan between the shareholder and the bank. Both deposit accounts of Profit Corporation had zero balances at the time the loan was made. Loss Corporation also had a separate account at this same bank.

On the same day, the loan was granted to the shareholder he deposited the \$800,000 into the account of Loss Corporation. This was recorded on the corporate books as follows:

**Loss Corporation:**

Cash	800,000
Note Payable—Shareholder	800,000

At the same time this transaction was occurring, Loss Corporation advanced \$800,000 to Profit Corporation. The entries on each of the corporate books were as follows:

**Loss Corporation:**

Note Receivable—Profit Corp	800,000
Cash	800,000

**Profit Corporation:**

Cash	800,000
Note Payable—Loss Corp	800,000

After this transaction Loss Corporation simply had on its books a note receivable from Profit of \$800,000 to match its \$800,000 note payable to the shareholder. Its infusion of cash was only momentary. The next step in this labyrinthine process found Profit Corporation loaning the shareholder the \$800,000 it just borrowed from Loss Corporation. On the books of Profit Corporation, the following entry was made:

**Profit Corporation:**

Note Receivable—Shareholder	800,000
Cash	800,000

After this transaction, Profit Corporation’s books showed that it had no cash, but only a receivable from the shareholder to balance the payable to Loss Corporation. The shareholder then used the \$800,000 to repay the bank loan. This loan from Profit Corporation and the shareholder’s payment to the bank occurred approximately one week after the day the shareholder obtained the bank loan.

When the fog had finally lifted from this circular flow of funds, Loss Corporation and Profit Corporation had the following balance sheet effects, looking strictly at these transactions.

**Loss Corporation:**

Assets:	
Note Receivable—Profit Corp	800,000
Liabilities:	
Note Payable—Shareholder	<u>800,000</u>
Increase in Net Worth	-0-

**Profit Corporation:**

Assets:	
Note Receivable—Shareholder	800,000
Liabilities:	
Note Payable—Loss Corp	<u>800,000</u>
Increase in Net Worth	-0-

One week after granting the \$800,000 loan to the shareholder, the bank had its money back and neither corporation had any increase in cash. Both corporations’ net worth had not increased at all, as each asset was matched by an equal liability. In particular, Loss Corporation’s books only reflected one new asset, a receivable from Profit Corporation, to match its own payable to the shareholder.

**The Kaplan Decision: Court Analysis**

The IRS denied any tax basis in Loss Corporation to the shareholder, who then appealed to the Tax Court. In its agreement with the IRS, which denied any loss deduction for the shareholder, the court reviewed the

economic outlay doctrine. It is not enough, said the court, that the shareholder directly advance funds to the corporation. There must be a transaction which, in substance, leaves the shareholder poorer in a material sense. The economic outlay doctrine ensures that the transaction creating basis has some economic substance beyond the creation of a tax deduction.<sup>19</sup>

In the case at hand, there was nothing but a series of checks written on accounts at the same bank, all in a very short period of time. At the end of this process, the shareholder was only poorer by about \$1,000 in bank fees. Moreover, none of the corporations had any net infusion of cash. Loss Corporation, in particular, had only the receivable from Profit Corporation to match its payable to the shareholder. Neither Profit Corporation nor Loss Corporation, nor the shareholder, had any real change in their economic positions after the entire process had been consummated.

In its denial of tax basis to the shareholder, the court cited the recent decision by the Eighth Circuit in *Oren*.<sup>20</sup> In this case, there was a similar circular flow of funds. The taxpayer borrowed funds from one successful S corporation and then loaned the money to two other S corporations in which he had no tax basis for loss deductions. The two loss corporations then immediately loaned the money back to the successful corporation. As the court noted in *Oren*, the only significance of the transactions was the circular route of various checks and the execution of promissory notes. The economic positions of the parties did not change. Such was the case in *Kaplan*, and the decision was the same. There must be some economic substance to a direct loan from the shareholder to the loss corporation. The mere form of a direct loan is not sufficient.

**The Ruckriegel Decision: Fact Pattern**

In *Ruckriegel*, the taxpayers were two brothers who were both equal 50 percent shareholders in an S corporation as well as equal 50 percent partners in a partnership.<sup>21</sup> The S corporation operated a chain of fast food restaurants that incurred substantial losses. In order to establish tax basis in the S corporation, the two taxpayers had the partnership borrow over \$6 million from commercial banks, and then transfer these funds to the S corporation. All of the loans were guaranteed by the S corporation, the partnership and the two taxpayers. The transfers were of two distinct types.

First, the partnership made direct transfers to the S corporation, which accounted for approximately \$4 million. The direct transfers from the partnership

to the S corporation were initially recorded on the books of the S corporation as a note payable to the partnership. Subsequently, the note payable was changed on the S corporation's books to reflect a note payable to the taxpayer-shareholders instead of the partnership, as follows.<sup>22</sup>

**S Corporation:**

Note Payable—Partnership	4,000,000
Note Payable—Shareholders	4,000,000

This reclassification of the S corporation debt occurred a few years after the original entry, and was authorized by a corporate directors' meeting, also occurring years after the original debt was incurred and the original loan payable from the S corporation to the partnership was established.

In the second set of loan transactions, the partnership loaned \$1 million to each of the taxpayers, who then loaned the money, totaling \$2 million, to the S corporation in their capacity as shareholders of the corporation. These indirect transfers were recorded on the partnership books as notes receivables from the taxpayers as partners. On the S corporation books, the loans were recorded as notes payable to the taxpayers, as shareholders. In summary:

**Partnership:**

Note Receivable—Partners	2,000,000
Cash	2,000,000

**S Corporation:**

Cash	2,000,000
Note Payable—Shareholders	2,000,000

The taxpayers used all \$6 million for tax basis in the S corporation for deducting losses from the S corporation. It was their contention that not only the indirect loans but also the direct advances from the partnership to the S corporation created tax basis. The IRS took the exact opposite position, arguing that not only the direct loans from the partnership, but also the indirect loans, were in substance debt from the S corporation to the partnership, and therefore no tax basis in the S corporation should be allowed the taxpayers.

**The Ruckriegel Decision:  
Court Analysis**

In adjudicating the issue, the Tax Court reached a "split decision." It determined that the direct transfers from the partnership to the S corporation did not provide tax basis to the taxpayers as shareholders,

notwithstanding the fact that the loans had come from a commonly controlled entity of the taxpayers, and despite the fact that the taxpayers had personally guaranteed the loans. On the other hand, the taxpayers were granted tax basis for the indirect transfers, *i.e.*, the loans from the partnership to the taxpayers followed by a loan from the taxpayers to the S corporation.

The court first noted that just because the partnership was a passthrough entity owned by the taxpayers did not mean that the substance of the loan from the partnership to the S corporation was one from the taxpayers to the S corporation.<sup>23</sup> Moreover, because the taxpayers were the sole owners of both entities, the court felt that they had a heavy burden in proving that the substance of the transactions should be accorded a tax result different from its form.<sup>24</sup> For example, the direct advances of \$4 million were made directly to the S corporation from the partnership. The taxpayers could have easily made those advances indirectly, from the partnership to the taxpayers, and then from the taxpayers to the S corporation. The fact that they did not arrange the transaction in this latter fashion was crucial to the court's decision.

In the end, the only argument that the taxpayers could really muster for tax basis in the \$4 million direct advances was the doctrine of the "incorporated pocketbook," *i.e.*, the partnership in this case being an entity that had continually acted as a *de facto* agent of the taxpayers in making payments for various personal expenses and investments. The direct advances of \$4 million to the S corporation by the partnership were simply, in substance, loans made by the partnership on behalf of the taxpayers as shareholders of the S corporation. Or so the taxpayers argued.

The Tax Court rejected this thesis as well. Citing the *Yates* and *Culnen* decisions, the court stated that the term "incorporated pocketbook" depicts a situation where a company has habitually made personal expenditures on behalf of the owner over an extended period of time. The existence of an "incorporated pocketbook" is a question of fact to be determined in each individual case. In the present instance, the partnership did indeed write a total of 55 checks on behalf of the taxpayers over the five-year period at issue. Approximately \$200,000 of the funds were checks made out to various taxing authorities, representing personal tax liabilities of the taxpayers, and approximately \$490,000 were for other personal items. However, the court reasoned

that these represented no more than distributions of partnership profits to the taxpayers, and were not of such a magnitude to warrant the partnership being considered an “incorporated pocketbook.”

Obviously, the court was using the *Ruckriegel* case to announce to taxpayers and their counsel that it is placing an extremely high standard on the concept of an “incorporated pocketbook.” It presumably put no importance on the personal guarantee that the taxpayers gave to the original loan from the bank to the partnership, which was the original source of the \$4 million of direct advances. The facts as presented in *Ruckriegel* indicated that the court could have easily decided in favor of the taxpayers, but it chose not to do so, probably because it did not want to open up yet another “Pandora’s Box” of litigation.

The court did allow tax basis for the \$2 million of indirect loans. The mere form of the loans was not controlling in this instance, however. Indeed the partnership first loaned the money to the taxpayers, who then loaned the money to the S corporation. But the court opined that this formality is not sufficient to establish a *bona fide* loan from the shareholder of a corporation, because the shareholder could be acting as a mere agent, a conduit, of the other entity, in this case the partnership.<sup>25</sup> If the shareholder is merely acting as an agent of the other entity, the “step transaction” doctrine would be invoked and the intermediate step of the loan to the shareholder from the other controlled entity is ignored.

The evidence in this case pointed otherwise, however. The taxpayers consistently recorded the transactions on the books of both the partnership and the S corporation as “back-to-back” loans, and consummated the entire loan process at some inconvenience to themselves. In addition, they personally guaranteed the bank loan to the partnership, which was the original source of the funds. Although the *Ruckriegel* court did not specifically state it, this guarantee is probably a crucial element in any “back-to-back” loan construction passing muster for tax basis.

The ease with which the Tax Court allowed tax basis for these indirect advances to the S corporation indicated the court’s somewhat lenient view of arranging loans to any S corporation in this fashion. It would be interesting to know how the court would have ruled if the \$4 million direct

advances from the partnership to the S corporation in *Ruckriegel* had been constructed along these same lines. Certainly, the taxpayers in *Ruckriegel* must be wondering this same thing.

If nothing else, the *Ruckriegel* decision is a further announcement to taxpayers and their counsel that direct advances from commonly controlled entities should be avoided at all costs. Instead, indirect “back-to-back” loans should be arranged and recorded on the books accordingly. The extra time and expense involved to construct the loans in this manner are well worth the tax savings that should result.

## Conclusion

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It is clear that the courts do not look favorably upon shareholder attempts to create tax basis in an S corporation from corporate debt to third parties, even those controlled by shareholders of the S corporation. Personal guarantees of corporate debt by the shareholder are uniformly rejected as granting tax basis, with the courts continuing to relegate the *Selke* precedent to tax obscurity. Moreover, the use of the “incorporated pocketbook” doctrine, though offering more hope to shareholders than the *Selke* doctrine, is itself contingent on proving a historical basis of the corporation acting as a habitual agent of the shareholder.

Clearly, if a shareholder desires tax basis in his corporation, but does not have sufficient personal funds for capital contributions (increasing stock basis), the obvious solution is to borrow funds from an unrelated party, preferably a commercial lending organization, securing the debt with property outside the corporation, and then advancing those funds to the S corporation. The advance should be undertaken as a capital contribution rather than as a loan to the corporation. Advancing the funds as a loan merely opens up the possibility that the IRS will argue that the debt is actually that of the corporation to the third-party creditor. This is especially true if the corporation secures the debt with its corporate property. Shareholders should not put themselves in the position of arguing, *ex post facto*, that S corporation debt to third parties is in substance a debt to the shareholder. The chances of winning this argument are so low that it is probably not worth the expense of litigation.

## ENDNOTES

- <sup>1</sup> *T. Gleason*, 92 TCM 250, Dec. 56,616(M), TC Memo. 2006-191.
- <sup>2</sup> *E.M. Selfe*, CA-11, 86-1 USTC ¶9115, 778 F2d 769, *rev'g and rem'g an unpublished district court decision*.
- <sup>3</sup> For examples of the court's opinion on this issue, see *E.T. Sleiman, Jr.*, 99-2 USTC ¶50,828, 187 F3d 1352, *aff'g*, 74 TCM 1270, Dec. 52,371(M), TC Memo. 1997-530; *D. Leavitt Est.*, CA-4, 89-1 USTC ¶9332, 875 F2d 420, *aff'g*, 90 TC 206, Dec. 44,557 (1988), *cert. denied*, 493 US 958, 110 S Ct 376 (1989); *F.G. Brown*, CA-6, 83-1 USTC ¶9364, 706 F2d 755, *aff'g*, 42 TCM 1460, Dec. 38,361(M), TC Memo. 1981-608; *B.L. Spencer*, 110 TC 62 (1998), Dec. 52,554.
- <sup>4</sup> *W.H. Perry*, 54 TC 1293, Dec. 30,176 (1970); *S.J. Pike*, 78 TC 822, Dec. 39,037 (1982); and *Spencer, id.*
- <sup>5</sup> *Perry, id.*; See also, *F.H. Hitchins*, 103 TC 711, Dec. 50,309 (1994).
- <sup>6</sup> *R.J. Reser*, CA-5, 97-1 USTC ¶50,416, 112 F3d 1258 (1997), *aff'g*, 70 TCM 1472, Dec. 51,032(M), TC Memo. 1995-572.
- <sup>7</sup> Rev. Rul. 70-50, 1970-1 CB 178.
- <sup>8</sup> Rev. Rul. 75-144, 1975-1 CB 277.
- <sup>9</sup> *T.J. Miller*, 91 TCM 1267, Dec. 56,544(M), TC Memo. 2006-125. See also *D.S. Gilday*, 43 TCM 1295, Dec. 38,994(M), TC Memo. 1982-242, wherein this principle was first established by the Tax Court.
- <sup>10</sup> *Gilday, id.*
- <sup>11</sup> *W.H. Maloof*, CA-6, 2006-2 USTC ¶50,443, 456 F3d 645, *aff'g*, 89 TCM 1022, Dec. 55,985(M), TC Memo. 2005-75.
- <sup>12</sup> *S.P. Burnstein*, 47 TCM 1100, Dec. 40,997(M), TC Memo. 1984-74; *J.L. Shebestor*, 53 TCM 824, Dec. 43,915(M), TC Memo. 1987-246.
- <sup>13</sup> *Don E. Williams Co.*, 77-1 USTC 9221, 429 US 569, 97 S Ct 850.
- <sup>14</sup> *D.J. Culnen*, 79 TCM 1933, Dec. 53,856(M), TC Memo. 2000-139.
- <sup>15</sup> *Hitchins, supra* note 5; *M.G. Underwood*, CA-5, 76-2 USTC ¶9557, 535 F2d 309, *aff'g*, 63 TC 468, Dec. 33,016 (1975).
- <sup>16</sup> *C.E. Yates*, 82 TCM 805, Dec. 54,523(M), TC Memo. 2001-280.
- <sup>17</sup> Code Sec. 1368(a).
- <sup>18</sup> *M.O. Kaplan*, 90 TCM 296, Dec. 56,143(M), TC Memo. 2005-218.
- <sup>19</sup> *D.G. Oren*, CA-8, 2004-1 USTC ¶50,165, 357 F3d 854, *aff'g*, 84 TCM 50, Dec. 54,811(M), TC Memo. 2002-172.
- <sup>20</sup> *Oren, id.*
- <sup>21</sup> *S.P. Ruckriegel*, 91 TCM 1035, Dec. 56,485(M), TC Memo. 2006-78.
- <sup>22</sup> The amounts following for this discussion are approximations. The numbers are rounded to the nearest million for the sake of clarity.
- <sup>23</sup> *E.J. Frankel*, CA-3, 506 F2d 1051 (1974), *aff'g in an unpublished opinion*, 61 TC 343, Dec. 32,250 (1973).
- <sup>24</sup> *Shebestor, supra* note 12; *Burnstein, supra* note 12.
- <sup>25</sup> *R.M. Prashker*, 59 TC 172, Dec. 31,583 (1972).

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