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THE UNCERTAINTY OF BASIS IN WITH BACK-TO-BAC

For a number of years, the IRS and the courts have taken a particularly harsh position with respect to loan restructurings between related entities where the purpose of such restructuring was to obtain an increase in the taxpayer's basis in an S corporation, and in turn, enable the taxpayer to deduct losses incurred by the S corporation during the tax year. In essence, the IRS and the courts have refused to allow a shareholder to increase his or her basis in an S corporation (at least in the restructuring context), where the shareholder obtains funds from a related entity (as opposed to an unrelated third-party lender) that are then loaned or contributed by the shareholder to the S corporation. ● More recent developments suggest that the IRS may take the position, in certain circumstances, that a basis increase is inappropriate even where the loan restructuring involves an unrelated third party lender, and that in certain circumstances, the IRS may take the position that no basis increase should be granted even if the loan was *originally structured* (as opposed to restructured) as a back-to-back loan if the shareholder obtains the funds from a related entity. ● This article will



INCREASES IN CONNECTION CHECK LOANS TO S CORPORATIONS

briefly look at the basis limitation rules, and then review four recent decisions involving back-to-back loans and loan restructurings.

Basis Limitation on Pass Through of Losses and Deductions

Under Section 1363(a), an S corporation is generally treated as a pass-through entity and not as a taxable entity for federal income tax purposes, and, as such, its shareholders are generally subject to only one level of tax on its earnings. Section 1366(a)(1) generally provides that all items of income, loss, deduction, and credit of an S corporation pass through the corporation and are taxed directly to its shareholders in proportion to their ownership interests in the corporation.

In order for an S corporation shareholder to deduct his or her pro rata share of the S corporation's losses under Section 1366(a), the shareholder must have sufficient basis in S corporation stock or debt under the basis limitation rules of Section 1366(d).¹ Section 1366(d)(1) provides that the total amount of losses and deductions taken into account by an S corporation shareholder for any tax year cannot exceed the sum of:

1. The adjusted basis of the shareholder's stock in the S corporation.²
2. The shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder.³

To the extent that any losses or deductions passing through to the S corporation's shareholder are disallowed because of the basis limitation rules prescribed under Section 1366(d)(1), Section 1366(d)(2) provides for a carryover of such disallowed losses and deductions.⁴

Qualified Indebtedness. Although Section 1366(d)(1)(B) provides that a shareholder is entitled to deduct his or her proportionate share of the S corporation's losses and deductions to the extent of such shareholder's adjusted basis in the debt of the S corporation to him or her, it does not specifically define what constitutes



“indebtedness of the S corporation to the shareholder.” The Senate Finance Committee Report accompanying Section 1374(c)(2), the predecessor to Section 1366(d), indicates that the purpose of the section is to limit the amount of an S corporation's loss that may be deducted by a shareholder to the “adjusted basis of the shareholder's investment in the corporation.”⁵ Seizing upon this language (correctly or incorrectly), the cases and rulings interpreting Section 1366(d)(1)(B)

have established two requirements that generally must be met in order for a loan to constitute “indebtedness of the S corporation to the shareholder” within the meaning of Section 1366(d)(1)(B):

1. The indebtedness must run directly from the S corporation to the shareholder.⁶
2. The shareholder must have made an “actual economic outlay.”

Recent Cases. Kaplan. In *Kaplan*, TCM 2005-217, the Tax Court held that the amounts loaned by a shareholder to his wholly owned S corporation did not constitute “indebtedness of the S corporation to the shareholder” within the meaning of Section

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1366(d)(1)(B), and as such, did not increase his basis in the S corporation by the amount of such indebtedness.

In *Kaplan*, the taxpayer was a real estate developer who conducted his operations through multiple entities, including several wholly owned S corporations. These wholly owned S corporations included: Marc Construction and Development Co. (Marc), Lakeview Development of Barrington, Inc. (Lakeview), Pleasant Prairie Development, Inc. (Pleasant Prairie), and Silver Glen Development, Inc. (Silver Glen).

For the tax year ending 12/31/1996, Marc sustained a loss of \$792,752, which could not be deducted by the taxpayer

under Section 1366(d) since he had a zero basis in Marc. The taxpayer therefore took the steps outlined below in an attempt to create sufficient basis to allow him to deduct the substantial losses of Marc in 1997:

- The taxpayer borrowed \$800,000 from the bank, evidenced by a duly executed promissory note. Additionally, the taxpayer prepaid \$1,000 of finance charges to the bank.
- The taxpayer transferred \$800,000 to Marc as a loan.
- Marc used the \$800,000 to pay debts to related corporations (Lakeview and Pleasant Prairie).
- Lakeview and Pleasant Prairie then loaned the \$800,000 to the taxpayer.

- The taxpayer repaid the \$800,000 to the bank.

The Tax Court, citing *Oren*, TCM 2002-172, *aff'd*, 357 F.3d 854 (CA-8, 2004), and *Bergman*, 74 F.3d 928 (CA-8, 1999), stated that, to increase basis in an S corporation, the shareholder must make an actual economic outlay. In order to satisfy the actual economic outlay requirement, the court also stated that, even in circumstances where the taxpayer purports to have made a direct loan to the S corporation, the taxpayer must show that the claimed increase in basis was based on a transaction that left the taxpayer "poorer in a material sense."

In applying this standard, the court concluded that it could envision no realistic scenario in which the taxpayer's purported loan to Marc would have or could have made him poorer, and as such, held that the taxpayer made no economic outlay with respect to any part of the \$800,000 transferred to Marc. Consequently, the taxpayer was denied an increase in basis for the \$800,000 loaned by him to Marc.

Ruckriegel. In *Ruckriegel*, TCM 2006-78, the Tax Court held that loans made to an S corporation from a related partnership, which the taxpayers argued were subsequently restructured as loans from the partnership to the shareholders and then from the shareholders to the S corporation, did not increase the shareholders' basis in the S corporation under Section 1366(d)(1)(B).

Ruckriegel involved two brothers who owned both an S corporation and a partnership. During the years at issue, the partnership operated at a profit while the S corporation operated at a loss. Each of the brothers' basis in his S corporation stock was zero. For the years at issue, the brothers claimed that they had basis in the S corporation as a result of two kinds of advances. The first were wire transfers that initially had been made by the partnership directly to the S corporation; however, at some point during the three-year period after the advances had been made, backdated notes were executed between the partnership and the brothers and between the brothers and the S corporation. The second kind of advance involved wire transfers from the partnership to the brothers followed by wire transfers from

the brothers to the S corporation. The brothers claimed that all the advances were, in substance, direct loans from them to the S corporation, such that their basis in the S corporation should be increased. The IRS disagreed, contending that all of the advances were “inherently” loans from the partnership to the S corporation because the brothers had not made an “actual economic outlay” of their own funds.

Before analyzing the particular facts, the Tax Court made some general observations regarding the law. Importantly, the court rejected the IRS argument that the “economic outlay” requirement is met only if a taxpayer invests in or lends to the S corporation either his own funds or funds that are borrowed from an unrelated party to whom he is personally liable. Instead, citing *Yates*, the court stated that “the fact that funds lent to an S corporation originate with another entity owned or controlled by the shareholder of the S corporation does not preclude a finding that the loan to the S corporation constitutes an ‘actual economic outlay’ by the shareholder.” The court in *Ruckriegel* further stated: “. . . we find no categorical rule, under § 1366(d)(1)(B), the regulations thereunder, see Reg. § 1.1366-2(a), Income Tax Regs., the applicable case law, or indeed, as a matter of plain common sense, requiring a common shareholder to fund the S corporation’s losses with funds from his mattress or with

funds borrowed by him from a bank or other unrelated party, rather than with funds obtained from another controlled entity, in order to obtain a basis in the unprofitable S corporation to the extent of the funding.”

With respect to the advances that were made by the partnership to the S corporation, the Tax Court was willing to entertain the brothers’ argument that, in substance, the brothers had loaned money to the S corporation. In this regard, the court indicated that the brothers’ position, in effect, was premised on two grounds: (1) that the brothers used the partnership as an “incorporated pocketbook” to discharge their personal obligations, and (2) that the advances were intended to constitute bona fide back-to-back loans that would give rise to basis. The court, however, noted that where there are transactions between related parties, the taxpayer bears a heavy burden of demonstrating that the substance of a transaction is different than its form.

With respect to the “incorporated pocketbook” argument, the court explained that the term “incorporated pocketbook” describes a taxpayer’s “habitual practice of having his wholly owned corporation pay money to third parties on his behalf.” In this regard, the court noted that whether such a practice is “habitual” and whether such a practice proves that “any ambiguous payment is being made by the corporation on behalf

of its owner (as opposed to on its own behalf)” are questions of fact. Based on the facts of the particular case (including the number of checks the partnership wrote to the brothers as partnership distributions), the court found that the brothers did not use the partnership for personal purposes to an extent that would justify treating the partnership’s advances to the S corporation as advances on behalf of the brothers.

With respect to whether the advances from the partnership to the S corporation were intended by the parties to constitute loans from the brothers directly to the S corporation, the court found that the form of the transaction as a loan from the partnership to the S corporation was not necessarily fatal. The court also found that, unlike other cases in which there had been a “brief, circular flow of funds beginning and ending with the original lender,” the loans to the S corporation in the instant situation had a valid business purpose of providing working capital for the operation and expansion of the S corporation’s business. Nonetheless, the court indicated that the brothers’ intent to establish a back-to-back loan structure in connection with the direct



In order for an S corporation shareholder to deduct his or her losses, the shareholder

¹ In addition to the basis limitation rules of Section 1366(d), S corporation shareholders seeking to deduct their pro rata share of an S corporation’s losses are faced with two other loss limitation rules. First, the S corporation shareholder must have a sufficient amount “at risk” to deduct a pro rata share of the corporation’s losses under the at-risk limitation rules of Section 465. See generally August & Looney, “S Shareholders Must Still Be Wary Of At-Risk Rules: Part II,” 3 J. S Corp. Tax’n 179 (1992); August & Looney, “S Shareholders Must Still Be Wary Of At-Risk Rules: Part I,” 3 J. S Corp. Tax’n 99 (1991); August, “Basis Traps Under Subchapter S: Competing In The Basis Triathlon,” 48 N.Y.U. Inst. on Tax’n ch. 7 (1990); Wiesner, “S Corporation Basis, At-Risk And Passive Loss Limitations After Tax Reform,” 46 N.Y.U. Inst. on Tax’n ch. 12 (1988); Bravenec, “S Corporations and Shareholders Under the At-Risk Rules of Section 465 - Revisited,” 36 Tax Law 765 (1983); Bravenec, “Subchapter S Corporations and Shareholders Under the At-Risk Rules of Section 465,” 36 Tax Law. 93 (1982). Additionally, the shareholder’s pro rata share of an S corporation’s

losses will be subject to the passive activity loss limitation rules of Section 469.

² Section 1366(d)(1)(A).

³ Section 1366(d)(1)(B).

⁴ The carryforward of losses suspended under Section 1366(d)(2) is *not* indefinite. The carryforward will generally cease when the shareholder terminates his or her interest in the S corporation, dies, or the corporation ceases to be an S corporation.

⁵ S. Rep. No. 1983, 85th Cong., 2d Sess. 220 (1958).

⁶ But see *Miles Prod. Co.*, TCM 1969-274, *aff’d on other issues*, 457 F.2d 1150 (CA-5, 1972), where a shareholder was allowed to increase his basis in an S corporation with respect to a loan made to the S corporation from a related corporation, since the loan was treated as a constructive dividend to the shareholder followed by a capital contribution of the amount received as a dividend to his S corporation. See also, Culnen, TCM 2000-139 and *Yates*, TCM 2001-28, which utilized an “incorporated pocketbook” theory to grant shareholders basis increases for loans made

directly by their controlled corporations to their S corporations.

⁷ Although it may make sense to require the taxpayer to be poorer in a material sense after the transaction is completed than he was before the transaction began in determining whether the shareholder is entitled to claim a *deduction*, the application of this test to determine whether a shareholder is entitled to a *basis increase* makes no sense.

⁸ If the IRS and the courts assume that a taxpayer will never make demand upon him or herself for payment, no loans made between related corporations or between shareholders and their controlled corporations would ever be treated as indebtedness for purposes of the Code. Such a position not only ignores the form of such transactions, but also the economic substance of such transactions. Regardless of whether a loan is between related parties or unrelated parties, the loan should constitute indebtedness for all purposes of the Code so long as it represents bona fide indebtedness and is not a sham.

⁹ See *Ruckriegel*, *supra*.

payments by the partnership would have to be “clearly manifested by the actions of the parties to those transactions.” Based on the facts of the case, the court found that the brothers had failed to meet this burden. Among other things, the court found that various backdated documents were not sufficient to establish that the parties had, at the time the funds were advanced, intended for the brothers to be lending funds to the S corporation and for the S corporation to be obligated directly to the brothers.

By contrast, the court found that the advances that were actually made from the partnership to the brothers and from the brothers to the S corporation did result in a basis increase. The court reasoned that “it is the form of the wire transfer payments and the manner in which they were consistently recorded on both [the partnership’s and the S corporation’s] books that furnish the evidentiary support” for the brothers’ position that the loans gave them basis in the S corporation. The court further remarked that, “although we would normally be inclined to view petitioners’ participation in the transactions, if they were essentially conduits for transfers of funds from

indebtedness of the S corporation under Section 1366(d)(1)(B) in connection with a loan restructuring pursuant to which the original loan made by a third-party lender (Huntington National Bank) to the S corporation was restructured as a loan from the bank to the shareholder, and then as a loan from the shareholder to his S corporation. Additionally, the Tax Court held that the shareholder was “at risk” within the meaning of Section 465 with respect to the indebtedness of the S corporation to him, and as such, was entitled to deduct the losses of the S corporation passing through to him under Section 1366 for the years in issue.

In *Miller*, the S corporation was incorporated in 1988 and was engaged in the business of manufacturing mobile and modular medical diagnostic facilities. The taxpayer was the sole shareholder of the S corporation. The S corporation arranged with the bank to obtain financing for the business and loans were initially made directly by the bank to the S corporation. Subsequently, because of financial difficulties, the taxpayer obtained four outside investors in the S corporation (the “Rapp Group”), which made capital contributions to the S corporation in exchange for a certain percentage of the S corporation’s stock. In connection with the Rapp Group’s investment in the S corporation, the S corporation obtained a line of credit from the bank. The taxpayer executed an

poration, which used those funds to satisfy the original letter of credit to the bank, which was canceled. The S corporation executed a promissory note and a security agreement (pledging its assets as security for the loan) in favor of the shareholder, which the shareholder in turn collaterally assigned to the bank as security for the loan made by the bank to the shareholder.

Several years later, the S corporation became insolvent and the Rapp Group, as guarantors, paid \$900,000 to the bank in partial satisfaction of the loan. The Rapp Group then satisfied the remaining \$475,000 on the loan by taking out personal loans from the bank and using the proceeds to purchase the bank’s note to the shareholder. Concurrently, the shareholder and the Rapp Group formed a new entity which purchased the remaining assets of the S corporation and completed the S corporation’s outstanding contracts. Upon completion of those contracts, the proceeds were paid to the Rapp Group, which in turn used those proceeds to repay their personal loans to the bank (the \$475,000). The shareholder did not make any payments to the Rapp Group to reimburse them for payments to satisfy the loan pursuant to their guarantees, nor did the Rapp Group seek reimbursement from the shareholder.

The shareholder increased his basis in the S corporation as a result of the loan restructuring, and consequently

her pro rata share of the S corporation’s must have sufficient basis in S corporation stock or debt.

[the partnership to the S corporation,] as without legal significance, in this instance petitioners’ involvement, at some personal inconvenience, represented a concrete manifestation of an intent to create debt” from the S corporation to the brothers and from the brothers to the partnership.

Miller. In *Miller*, TCM 2006-125, the IRS once again has demonstrated its dislike for loans between taxpayers and their related entities in the S corporation context, and sought to further expand the universe of loans not qualifying for basis increases under Section 1366(d)(1)(B). The Tax Court held that the shareholder of an S corporation was entitled to increase his basis in the

unlimited guarantee for the S corporation’s indebtedness to the bank, secured by a second mortgage on his personal residence, and each member of the Rapp Group executed limited guarantees with respect to the S corporation’s indebtedness to the bank.

Subsequently, based on advice from the shareholder’s tax advisor at Ernst & Young, a decision was made to restructure the loan arrangement so that the shareholder would be able to increase his basis in the S corporation to take advantage of the losses incurred by the S corporation during the years in issue. Specifically, the bank reissued the line of credit to the shareholder personally, who in turn loaned the funds to the S cor-

deducted substantial losses incurred by the S corporation during the years in issue. The IRS argued that the shareholder was not entitled to any basis increase as a result of the loan restructuring because the S corporation remained the “true borrower” on the bank loan, and therefore disallowed the losses claimed by the shareholder. Additionally, the IRS argued that the shareholder was not “at risk” for the amounts borrowed from the bank and then loaned to the S corporation, and as such, did not increase his basis in the S corporation. Finally, the IRS argued in the alternative that if the shareholder was entitled to a basis increase as a result of the loans so that the deductions were

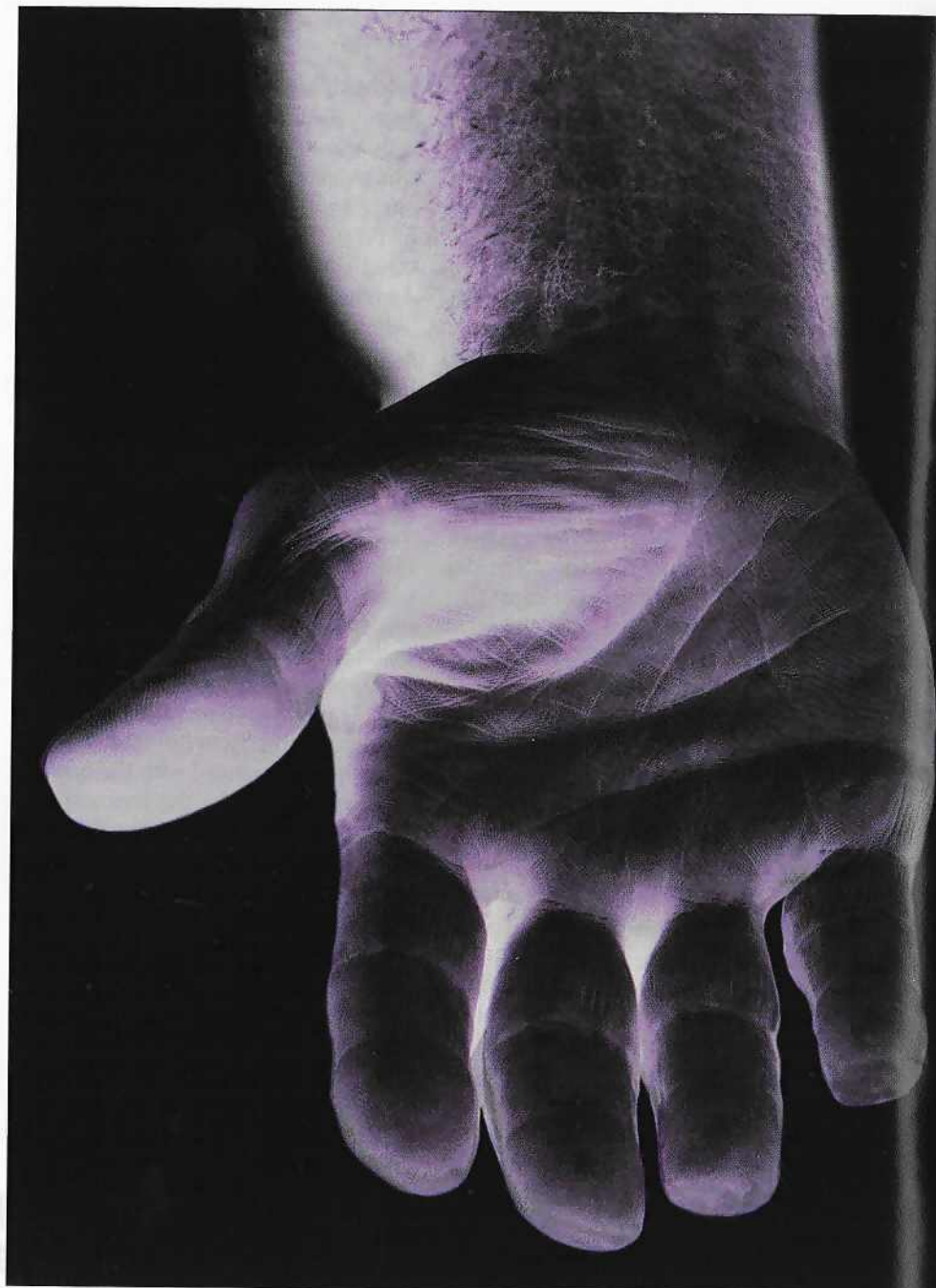


allowable, the payment to the bank by the Rapp Group under its guarantee constituted taxable forgiveness of debt income to the shareholder under Section 108.

Although the Tax Court allowed the shareholder to increase his basis as a result of the loans restructurings, it unfortunately reiterated its past reasoning that in order for a shareholder to be entitled to a basis increase, the shareholder must have made an "actual economic outlay" that leaves the taxpayer "poorer in a material sense" than he was before the transaction. Additionally, the court stated that where the source of funding for a back-to-back loan is a related party rather than an independent third-party lender, there may not be an economic outlay sufficient to create basis since the shareholder's repayment of the funds is uncertain (because the repayment is to a related party). Furthermore, the court stated that the presence of a third-party lender as the source of the funds lent by the shareholder to his S corporation is an important factor in determining whether the shareholder has made an actual economic outlay.

The court also went on to find that the taxpayer was sufficiently "at risk" within the meaning of Section 465 with respect to the loan to the bank, rejecting the IRS's argument that certain guarantee waivers executed by the Rapp Group in favor of the shareholder resulted in the shareholder being "protected against loss" within the meaning of Section 465(b)(4).

Finally, the court concluded that, although the shareholder did realize dis-



¹⁰ In *Prashker*, 59 TC 172 (1972), the IRS argued, and the Tax Court found, that the taxpayer-shareholder could not apply the attribution rules of Section 267 to treat a loan to his S corporation from an estate in which the shareholder was the sole beneficiary as a loan from the shareholder, and as such, the loan between the estate and the S corporation did not constitute indebtedness of the S corporation to the shareholder within the meaning of Section 1366(d)(1)(B). While denying taxpayers the use of an attribution rule in their favor, the IRS and the courts are implicitly applying an attribution rule to their detriment, by treating funds that are obtained by a shareholder from a related entity as not qualifying to increase the shareholder's basis in an S corporation when such funds are loaned (or contributed) by the shareholder to his or her S corporation. This is not only inequitable, but also unauthorized by the Code. Additionally, at least one case has held that amounts loaned to shareholders by persons related to them, and then contributed by the shareholders to their S corporation, entitle the share-

holders to increase their basis in the S corporation. See *Millar*, TCM 1975-113, *rev'd on another issue*, 540 F.2d 184 (CA-3, 1976). Arguably, human nature being what it is, a shareholder may be less inclined to repay a loan to an individual to whom he is related than to the shareholder's own controlled or wholly owned corporation.

¹¹ For purposes of the at-risk limitation rules under Section 465, where an S corporation shareholder contributes or loans borrowed money to an S corporation, the shareholder's at-risk amount will increase only to the extent such shareholder is at risk with respect to such borrowed amounts. Under Prop. Reg. 1.465-24(a)(1), a taxpayer is considered at risk with respect to amounts borrowed for use in an activity to the extent the taxpayer is personally liable for repayment of the loan. Thus, where an S corporation shareholder borrows funds on a recourse basis from a corporation controlled by him or her, such shareholder generally will be considered at risk for the loan proceeds thereafter actually contributed or loaned to another S corporation by such shareholder.

¹² In the event that the S corporation has Subchapter C E&P, Section 1368(c) imposes a five-tier system of taxation for distributions made to shareholders. This system uses an "accumulated adjustments account" concept that consists of the accumulated gross income of the S corporation less deductible expenses and prior distributions following conversion to S corporation status. Section 1368(e).

¹³ Section 301(d) provides that the basis of property received in a distribution to which Section 301(a) applies shall be the fair market value of such property.

¹⁴ In *Miles Prod. Co.*, TCM 1969-274, *aff'd on other issues*, 457 F.2d 1150 (CA-5, 1972), the Tax Court held that a shareholder would be entitled to increase his basis in an S corporation where a loan payable by his S corporation to another corporation controlled by the shareholder was treated as if it were distributed to the shareholder as a dividend and then recontributed by him to his S corporation.



and the S corporation then used the loaned funds to satisfy the original indebtedness to the third-party bank. This is the exact situation presented in the *Miller* case. The IRS's and the court's position denying basis increases in connection with loan restructurings between related parties is highly questionable, and for the IRS to attempt to expand this position to loan restructurings involving an unrelated third-party lender is very disturbing.

TAM 200619021. In TAM 200619021, the taxpayers, husband and wife, were 50% partners in a partnership ("Partnership") and 50% shareholders in an S corporation ("S Corp"). For years Y1 through Y3, the Partnership loaned money to the taxpayers, the taxpayers in turn loaned money to S Corp, and the S Corp would then pay rent (presumably based on fair rental value) to the Partnership for property leased by the Partnership to the S Corp. The loans between Partnership and the taxpayers and between the taxpayers and S Corp were documented by duly executed promissory notes providing for principal payments at the end of the following year and stated interest. Except for one partial repayment of principal by S Corp to taxpayers, however, no repayments of either principal or interest were ever made with respect to any of the promissory notes.

The Partnership borrowed money on a non-recourse basis from a third-party lender to acquire and construct real property. Under the borrowing arrangement with the lender, no portion of the loan proceeds could be or were used in the loan arrangements between the taxpayers, the Partnership, and the S Corp, and loans from the Partnership to the taxpayers were only permitted if the third-party lender approved the loan, the proceeds were made from the net profits of the Partnership (after debt service payments to the third-party lender), and the proceeds were used to fund the activity of the Partnership. Additionally, in years Y2 and Y3, the taxpayers made loans (from sources other than the Partnership) to the S Corp (the "Additional Loans"), which the IRS conceded gave rise to basis in indebtedness within the meaning of Section 1366(d)(1)(B).

The taxpayers increased their basis in S Corp under Section 1366(d)(1)(B) by

charge of indebtedness income as a result of the Rapp Group's payment under its guarantee of \$900,000 to the bank, such amounts were excludable from the shareholder's gross income under Section 108(a)(1)(B) since the shareholder was insolvent at the time of the discharge.

Although the IRS and the courts have generally been unwilling to grant basis increases in connection with loan restructurings where the loan was originally structured as a loan from a related entity to the taxpayer's S corporation, the IRS and the courts have generally been willing to grant taxpayers a basis increase in connection with loan

restructurings where the original loan came from an unrelated third-party lender. Consequently, the *Miller* case represents an unwarranted expansion of the IRS's position in this area, since the IRS was seeking to deny a basis increase in connection with a loan restructuring that originally involved a loan from an unrelated third-party lender. This is directly contrary to a number of cases and rulings in the area. In fact, in Ltr. Rul. 8747013, the IRS ruled that shareholders would be permitted to increase their basis in an S corporation where the shareholders borrowed funds from a third-party bank, loaned such funds to the S corporation,

the amount of the loans made by the Partnership to them, and then from them to S Corp, and deducted losses of S Corp based on the increased basis. The IRS's position was that the taxpayers were *not* entitled to a basis increase under Section 1366(d)(1)(B) for the loans made to S Corp attributable to the funds borrowed by taxpayers from the Partnership.

The IRS, citing *Underwood*, 63 TC 468 (1975), *aff'd*, 535 F.2d 309 (CA-5, 1976), and *Oren*, TCM 2002-172, *aff'd*, 357 F.3d 854 (CA-8, 2004), concluded that as a result of the circular route of the funds (from the Partnership to taxpayers, from taxpayers to S Corp, and from S Corp back to the Partnership), the "economic insignificance" of the terms of the notes, the lack of repayment on the notes, and the limits imposed on the taxpayers' ultimate liability to the Partnership, it was clear that no "economic outlay" that left the taxpayers "poorer in the material sense" occurred. Consequently, the IRS concluded that the loans made by the taxpayers to S Corp did not give rise to basis in indebtedness within the meaning of Section 1366(d)(1)(B).

Additionally, because year Y1 was closed under the statute of limitations, the IRS determined that the taxpayers' basis in S Corp in the open years (Y2 and Y3) must be computed using previously deducted losses in excess of the basis in stock and indebtedness in the

same reasoning found in the loan restructuring cases to back-to-back loan situations where the loan was originally structured (rather than restructured) such that the taxpayer borrowed funds from a related entity and then loaned or contributed those funds to the S corporation. Both the IRS's and courts' reasoning in the loan restructuring area to deny basis increases to S corporation shareholders is without merit, and becomes even more egregious where such reasoning is applied to loans originally structured in this manner.

Summary of Recent Cases and Rulings. While *Ruckriegel* and several other Tax Court decisions (*Hitchens*, 103 TC 711 (1994), *Bhatia*, TCM 1996-429, *Culnen*, TCM 2000-139, and *Yates*, TCM 2001-280), seemed to indicate that the Tax Court had undergone a change of attitude with respect to granting basis increases in connection with the structuring or restructuring of loans between related entities, *Kaplan* and *Miller* (even though decided in favor of the taxpayer) and TAM 200619021, as well as several other cases (*Oren*, TCM 2002-172, *aff'd*, 357 F.3d 854 (CA-8, 2004) and *Thomas*, TCM 2002-108), represent setbacks for taxpayers. In TAM 200619021, the IRS now appears to be taking the position that basis increases should be denied where the source of the funds for a loan to an S corporation is from a related entity, *even if the loan is initially*

economic foundation. In an economic sense, a shareholder is *never* poorer after he makes a loan to his S corporation than he was before he made the loan (regardless of how the shareholder obtained the funds he is loaning to the S corporation). Rather, the shareholder has merely shifted his current assets from cash to notes receivable while his net worth has remained the same.⁷ Thus, the focus of the IRS and the courts in the loan restructuring context of whether a taxpayer-shareholder is poorer in a material sense after the transaction is completed than he or she was before the transaction began is misplaced.

The application by the IRS and the courts of the actual economic outlay requirement as developed primarily in the loan guarantee area to loan restructurings is simply inappropriate. No current economic outlay such as an actual transfer of funds was required in either Rev. Rul. 75-144, 1975-1 CB 277, or *Gilguy*, TCM 1982-242, where an unrelated third-party bank was involved and a basis increase was granted to the shareholders, and there is simply no justification for requiring a current economic outlay simply because the original loan was made by a related corporation rather than by an unrelated third-party lender.



The application of the economic outlay rule by the courts taxpayer is entitled to in

year that was closed (Y1). Consequently, even though the IRS determined that the Additional Loans satisfied the actual economic outlay doctrine and therefore would generally create basis in indebtedness to the shareholders under Section 1366(d)(1)(B), it concluded that any basis increase resulting from the Additional Loans had to be reduced by the amount of losses taken in excess of what should have been the shareholders' basis in the closed year.

TAM 200619021 represents an expansion of the IRS's "not so kind and gentle" approach to back-to-back loans in the S corporation area. With the issuance of TAM 200619021, the IRS has now signaled its intention to apply

structured in such a manner. Additionally, in *Miller*, the IRS seems to be taking the position that *even if a loan restructuring originally involved a third-party lender*, the taxpayer may not be entitled to a basis increase if it involves a circular flow of funds.

Loan Restructurings Should Result in Basis Increase

The distinctions being drawn by the IRS and courts are unwarranted and not justified under the Code. The application of the actual economic outlay doctrine by the courts is not only being made without any statutory authority, but is also being applied without any supportable

The IRS is simply assuming that if the loan is between related parties it will never be repaid and, therefore, that no real indebtedness exists.⁸ The IRS's concern that funds borrowed by a shareholder from his or her controlled or wholly owned corporation will not be repaid is misplaced. In the case of a loan to a shareholder by a corporation controlled (but not wholly owned) by such shareholder, the minority shareholders would have the right to bring an action to compel payment of the loan on behalf of the corporation in the event the shareholder does not repay the loan to the S corporation. In the context of a wholly owned corporation, third-party creditors would likewise have a cause of

action to compel payment of the loan by the shareholder to the S corporation.

The court's application of the economic outlay rule, as well as its application of a "source of funds" rule, in order to determine whether the taxpayer is entitled to increase his or her basis in the S corporation is both disturbing and misguided. In effect, the IRS is punishing S corporation shareholders for having access to cash from a source other than an unrelated third-party lender. The shareholder is being penalized solely because the source of funds is a related corporation rather than an unrelated third-party lender or from funds "from his mattress."⁹ The IRS is implicitly applying an attribution rule in the context of Section 1366(d)(1)(B), so that funds that are obtained by a shareholder from a related corporation and then loaned or contributed to an S corporation controlled by that same shareholder will not be treated as indebtedness of the S corporation to the shareholder. Because there is no such attribution rule contained in Section 1366(d) or in any other section of the Code, the IRS simply has no authority to apply such a rule.¹⁰ The economic outlay rule should have no application outside of the loan guarantee area.

Undoubtedly, the IRS would treat a loan to a

holder and an entity controlled by such shareholder, the shareholder should be permitted to treat funds obtained in this manner and then loaned to another S corporation as indebtedness of the S corporation to such shareholder within the meaning of Section 1366(d)(1)(B).

The distinctions being drawn by the IRS and the courts become even less compelling in situations in which the loan is distributed by the related entity to the shareholder, and in circumstances in which actual monies are transferred by the shareholder to the S corporation.

Basis Increase Is Appropriate if Loan Restructuring Involves Promissory Note Distribution to Shareholder. In addition to the reasons discussed above, where a promissory note payable by an S corporation (S-1) to another S corporation (S-2) controlled by a shareholder is distributed to such shareholder under Section 1368, the distributed loan should clearly constitute an indebtedness of S-1 to the shareholder under Section 1366(d)(1)(B), since the shareholder will have acquired a tax cost basis in such loan.

Under the general rules of Section 1368, the distribution of a loan will result in a reduction in the shareholder's basis in S-2 by the amount of the loan, and to the extent that the amount of the loan distributed exceeds the shareholder's basis in S-2, the shareholder will recognize taxable gain on such distribution.¹² Under Section

1366(d)(1)(B), the shareholder should be treated as having made an actual economic outlay within the intentment of Section 1366(d)(1)(B) since there is an *actual transfer of funds* from the shareholder to the S corporation. This is almost identical to the situation presented in Ltr. Rul. 8747013, where the IRS allowed the shareholder to increase his basis in the S corporation in connection with a loan restructuring. To deny a basis increase where a shareholder restructures a loan in this manner not only ignores the form of the transaction, but also the economic substance of the transaction since the shareholder transferred actual funds to the S corporation.

Conclusion

The position of the IRS and the courts, that amounts loaned by a shareholder to his or her wholly owned S corporation will *not* constitute indebtedness of the S corporation to the shareholder within the meaning of Section 1366(d)(1)(B), where the loan was originally structured as a loan from another corporation con-



In order to determine whether the increase his or her basis in an S corporation is misguided.

shareholder from his or her controlled or wholly owned S corporation as "indebtedness" for purposes of the imputed interest rules under Section 7872. Thus, it is inequitable for the IRS to treat such amounts as "indebtedness" for purposes of Section 7872, while at the same time not treating those same amounts as "indebtedness" for purposes of Section 1366(d)(1)(B) when the shareholder loans such funds to his or her S corporation. The IRS's position on basis increases in connection with loan restructurings between related entities is also more restrictive than the at-risk limitation rules under Section 465.¹¹

Quite simply, provided that there is a bona fide indebtedness between a share-

holder, the S corporation shareholder will acquire a basis in the distributed loan equal to the loan's fair market value.¹³

Consequently, where the loan restructuring is accomplished by means of a *distribution* of the loan to the shareholder, the shareholder is clearly entitled to treat the loan received in the distribution as an indebtedness of the S corporation to the shareholder under Section 1366(d)(1)(B) and to correspondingly increase his or her basis in the S corporation.¹⁴

Basis Increase Appropriate if Loan Restructuring Accomplished Through Actual Transfer of Funds to S Corporation. Where the loan restructuring is accom-

plished by having the debtor S corporation repay the loan to the creditor corporation, followed by an actual transfer of such funds by the creditor corporation to the shareholder as a loan, and, in turn, by the shareholder's actual transfer of such funds to the debtor S corporation as a loan, the shareholder should be treated as having made an actual economic outlay within the intentment of Section 1366(d)(1)(B) since there is an *actual transfer of funds* from the shareholder to the S corporation. This is almost identical to the situation presented in Ltr. Rul. 8747013, where the IRS allowed the shareholder to increase his basis in the S corporation in connection with a loan restructuring. To deny a basis increase where a shareholder restructures a loan in this manner not only ignores the form of the transaction, but also the economic substance of the transaction since the shareholder transferred actual funds to the S corporation.