CHAPTER 15

So You Think It's Easy to Obtain Basis Increases for Loans to S Corps? Think Again! Opportunities and Pitfalls in Structuring and Restructuring Loans to S Corporations

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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 the loan 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 taxable year. In essence, the IRS and the courts have refused to allow a shareholder to increase his 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) which 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 believes 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 examine TAM 9403003, which is the foundation for the IRS’s position in the loan restructuring area, as well as the cases relied upon by the IRS in support of its finding in TAM 9403003. The article then examines the requirements which must be met in order for a debt to constitute “indebtedness of the corporation to the shareholder” within the meaning of § 1366(d)(1)(B), so as to enable a shareholder to increase his basis for a loan made by the shareholder to an S corporation. This includes a detailed review of the “economic outlay theory” as developed by the IRS and the courts, as well as its application to the loan restructuring and back-to-back loan areas. A number of developments addressing basis increases in the S corporation context which have been decided since TAM 9403003 will be reviewed, focusing in particular on loan restructurings between related entities. This article will conclude by examining whether the rationale being used by the IRS and the courts is supportable from either a statutory basis or from an economic basis, and provide guidance on how loans can be successfully restructured to obtain a basis increase in accordance with the IRS’s and courts’ positions on loan restructurings.

§ 15.02 TAM 9403003 AND BERGMAN v. UNITED STATES

[1] Factual Background

In Bergman v. United States,¹ the Eighth Circuit Court of Appeals reversed and remanded the decision of the district court which had held (in summary judgment in favor of the taxpayers) that the amounts loaned by a shareholder to his wholly-owned S corporation constituted “indebtedness of the S corporation to the shareholder” within the meaning of § 1366(d)(1)(B), where the loan originally had been structured as a loan from another S corporation controlled by the shareholder to the shareholder’s wholly-owned S corporation. Interestingly, the Bergman case is the case upon which the facts of TAM 9403003 are based, in which the IRS (reaching the opposite result from that reached by the district court in Bergman) ruled that the amounts loaned by the shareholder to his wholly-owned S corporation did not constitute “indebtedness of the S corporation to the shareholder” within the meaning of § 1366(d)(1)(B), and as such, did not increase his basis in the S corporation by the amount of such indebtedness.

Under the facts of Bergman and TAM 9403003, an S corporation (S-1) controlled by the shareholder borrowed $780,000 from a bank and then loaned such funds to the shareholder’s wholly-owned S corporation (S-2). S-1 also loaned an additional $910,000 to S-2 during the same taxable year. Prior to the end of the taxable year (December 20, 1990) when it was apparent that S-2 had incurred substantial losses, S-2 repaid the $1,690,000 ($780,000 + $910,000) to S-1, S-1 loaned such amounts to the shareholder, who in turn loaned them to S-2. Mechanically, the amounts repaid by S-2 to S-1 were deposited in S-1’s bank account, S-1 drew checks on its bank account in the amount of $1,690,000, which were deposited into shareholder’s bank account, and shareholder drew checks on his bank account in the amount of $1,690,000, which were then deposited into S-2’s bank account. Additionally, the loans between S-1 and shareholder and between shareholder and S-2 were evidenced by duly executed promissory notes. In this manner, shareholder attempted to create sufficient basis to allow him to deduct the substantial losses incurred by S-2 during the taxable year.

[a] IRS’s Ruling in TAM 9403003

The IRS, citing Underwood v. Commissioner,2 Shebester v. Commissioner,3

¹ 74 F.3d 928 (8th Cir. 1999).
² 63 T.C. 468 (1975), aff’d, 535 F.2d 309 (5th Cir. 1976).
³ T.C. Memo 1987-246.
Griffith v. Commissioner,4 and Wilson v. Commissioner,5 concluded that the shareholder could not treat the amounts he loaned to S-2 as indebtedness of the S corporation to him under § 1366(d)(1)(B), since the shareholder had not made an actual economic outlay in such a manner that he was poorer in a material sense after the transaction than he was before the transaction began. Specifically, the IRS stated that when a taxpayer puts himself between his controlled S corporations, it is not clear that the taxpayer will ever make demand upon himself for payment. Consequently, unless the taxpayer makes an actual payment, there is no actual economic outlay as required under § 1366(d)(1)(B).

The IRS also distinguished Gilday v. Commissioner6 and Revenue Ruling 75-1447 (in which shareholders were granted an increase in basis with respect to similar loan restructurings) since the obligees on the shareholders’ notes in both of those situations were unrelated third-party banks rather than corporations controlled by the shareholders.

[b] District Court’s Ruling in Bergman

As discussed above, the facts of the Bergman case are identical to the facts presented in TAM 9403003, since the taxpayer in Bergman was the taxpayer for which TAM 9403003 was requested. The district court, unlike the IRS in TAM 9403003, found that the Bergman case was controlled by the Gilday case. In Gilday, a loan was made by a third-party bank directly to an S corporation, and was personally guaranteed by the shareholders of the S corporation. The shareholders subsequently substituted their own promissory notes for the corporation’s promissory note to the third-party bank, which released the S corporation from liability. The S corporation then issued new promissory notes to its shareholders. The court in Gilday concluded that the substitution of the shareholders’ promissory notes, together with the acceptance of the shareholders’ promissory notes by the bank and the bank’s release of the S corporation, caused the indebtedness of the S corporation to accrue to the shareholders. As such, the shareholders were permitted to increase their respective bases in the S corporation under § 1366(d)(1)(B). See also, Revenue Ruling 75-1448 where the IRS permitted the shareholders of an S corporation to increase their basis in the S corporation in connection with a loan restructuring almost identical to the loan restructuring which occurred in Gilday.

In Bergman, the district court concluded that the Gilday decision established the principle that funds loaned to an S corporation by a shareholder may have been loaned by a third party to the shareholder, without changing the shareholder’s ability to claim a basis increase in the S corporation. Consequently, the district court found that under the principles of the Gilday decision, the loan from Mr. Bergman to his wholly-owned S corporation, regardless of the source of such funds, created a tax basis under § 1366(d)(1)(B). The district court also found that this conclusion was supported by the plain language of § 1366, which does not place any limitations on the type or manner of indebtedness necessary to increase a shareholder’s basis in an S corporation.9

The district court also went on to reject the IRS’s argument that Mr. Bergman should not be entitled to increase his basis in the S corporation as the result of the loan restructuring because of the substance over form doctrine. The IRS argued that because Mr. Bergman borrowed the money from his own controlled corporation, as opposed to an unrelated third party as in Gilday, the substance of the transaction was actually a loan from his controlled corporation to his wholly-owned S corporation. The district court rejected the IRS’s argument and found that in the absence of proof that the loan was a sham, the loan should be respected for tax purposes even though the taxpayer obtained the funds he loaned to his S corporation from another controlled corporation.

The district court additionally rejected the IRS’s argument that the taxpayer should be denied a basis increase because he made no “actual economic outlay” in connection with the loan restructuring. Specifically, the district court held that the actual economic outlay doctrine (as developed in loan guaranty cases) had no application to a loan restructuring case not involving personal guarantees.

The district court concluded that although transactions between commonly controlled corporations and their shareholders merit closer scrutiny than transactions involving unrelated parties, there was no valid reason that the loan from Mr. Bergman’s controlled corporation to him should be treated any differently than the loan from the bank to the shareholders in Gilday. As such, the district court held

5 T.C. Memo 1991-544.
7 1975-1 C.B. 277.
8 1975-1 C.B. 277.
9 See also, Gurd v. Commissioner, T.C. Memo 1987-30 (shareholders’ basis in S corporation increased where shareholders borrowed funds from bank and then loaned such funds to their S corporation); and Letter Ruling 8747013 (shareholders’ basis in S corporation increased where shareholders borrowed funds from bank and then loaned proceeds to their S corporation, which then repaid its existing bank loan).
that the restructured loan from the taxpayer to his wholly-owned S corporation constituted "indebtedness of the S corporation to the shareholder" within the meaning of § 1366(d)(1)(B).

[c] The Eighth Circuit's Decision in Bergman

In reversing the district court's granting of summary judgment in favor of the taxpayer and remanding the case back to the district court, the Eighth Circuit specifically found that an S corporation shareholder must make an actual economic outlay to increase his basis in the S corporation, and that the economic outlay doctrine applies not only to loan guarantees, but also to other situations. Specifically, the Eighth Circuit found that when the evidence was viewed in a light most favorable to the IRS, material issues remained as to whether the taxpayer intended to repay the loan to S-1, and whether he gave money to S-2 in a manner which made him "poorer in a material sense." The Eighth Circuit's decision is both disappointing and disturbing, as it seems to be relying on the IRS's position in this area as well as the position taken by a number of cases which, in the authors' opinion, misapplied the law.10

§ 15.03 BASIS LIMITATION ON PASS THROUGH OF LOSSES AND DEDUCTIONS


Under § 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 interest in the corporation.

In order for an S corporation shareholder to deduct his pro rata share of the S corporation's losses under § 1366(a), the shareholder must have sufficient basis in S corporation stock or debt under the basis limitation rules of § 1366(d).11

10 Following the Eighth Circuit's render of the case to the district court, the IRS and the taxpayer settled the case, and as such, no further decisions were rendered.


Additionally, the shareholder's pro rata share of an S corporation's losses will be subject to the passive activity loss limitation rules of § 469.12

12 Section 1366(d)(1)(A).

13 Section 1366(d)(1)(B).

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

generally must be met in order for a loan to constitute “indebtedness of the S corporation to the shareholder” within the meaning of \$ 1366(d)(1)(B):  

1. The indebtedness must run directly from the S corporation to the shareholder; and  

2. The shareholder must have made an “actual economic outlay.”  

While the IRS and the courts generally have been consistent in their application of the requirement that the loan run directly from the S corporation to the shareholder, they have been inconsistent in their application of the requirement that the S corporation shareholder make an actual economic outlay.  

[3] Loan Must Run Directly from the S Corporation to the Shareholder  

The IRS and the courts have generally held that the indebtedness of the S corporation must run directly to the shareholder himself, and not to a related entity, in order for the shareholder to increase his basis in the S corporation.16 Thus, shareholders have been denied an increase in their S corporation basis with respect to loans made to S corporations by other corporations,17 partnerships,18 trusts,19 and estates20 in which the shareholders held an interest. In fact, in Bader

16 But see Miles Prod. Co. v. Commissioner, T.C. Memo 1969-274, aff’d on other issues, 457 F.2d 1150 (5th Cir. 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 \$ 15.06[2] infra for a discussion of the effect that a distribution of a loan between related corporations has on a shareholder’s basis in an S corporation. See also, discussion of the “incorporated pocketbook” theory at \$ 15.03[4] infra.  

17 Burnstein v. Commissioner, T.C. Memo 1984-74 (shareholders not allowed to increase basis where their S corporation borrowed money from another S corporation in which the shareholders also owned an interest).  

18 Frankel v. Commissioner, 61 T.C. 343 (1973), aff’d without published opinion, 506 F.2d 1051 (3rd Cir. 1974); and Revenue Ruling 69-125, 1969-1 C.B. 207. (shareholders not allowed to increase basis where their S corporation borrowed money from a partnership in which the shareholders were partners).  

19 Robertson v. United States, 73-2 U.S.T.C. (CCH) \$ 9645 (D. Nev. 1973) (shareholders not allowed to increase basis where their S corporation borrowed money from a trust in which the shareholders were beneficiaries).  

20 Prashker v. Commissioner, 59 T.C. 172 (1972) (shareholder not allowed to increase basis where S corporation borrowed money from an estate in which the shareholder was the sole beneficiary).  

v. Commissioner,21 the IRS denied an S corporation shareholder a basis increase even though the loan had originally been made by a third-party bank to the shareholder, who in turn had loaned such funds to the S corporation, since the loan had been restructured so that it ran directly from the bank to the S corporation (rather than to the shareholder).  

[4] Incorporated Pocketbook Theory  

Although the courts and the IRS have historically required that the indebtedness of the S corporation run directly from the S corporation to the shareholder and not to another entity in which the shareholder owns an interest in order for a shareholder to increase his basis under \$ 1366(d)(1)(B), several recent cases have used the so-called “incorporated pocketbook” theory to find that indirect loans did result in basis increases.  

[a] Culnen v Commissioner  

In Culnen v. Commissioner,22 the Tax Court held that amounts transferred by the taxpayer-shareholder’s wholly-owned C corporation to an S corporation in which the taxpayer-shareholder held varying interests during the years in issue, and payments made by the C corporation in payment of expenses of the S corporation, constituted “indebtedness of the S corporation to the shareholder” within the meaning of \$ 1366(d)(1)(B). As such, the taxpayer-shareholder was entitled to increase his basis in the S corporation by such amounts and therefore able to deduct the losses incurred by the S corporation during the tax years in issue.  

The taxpayer presented evidence that for many years (including the years in issue), the taxpayer-shareholder had used the C corporation as an “incorporated pocketbook,” having the corporation make payments on his behalf, which payments were consistently posted to the C corporation’s books as loans to the taxpayer. The Tax Court found this evidence persuasive, and, in effect, treated the amounts as if they had been loaned first from the C corporation to the taxpayer, and then from the taxpayer to the S corporation.  

[b] Yates v. Commissioner  

In Yates v. Commissioner,23 the Tax Court held that various transfers made by

22 T.C. Memo 2000-139. For a more detailed discussion of this case, see \$ 15.05[4] infra.  
23 T.C. Memo 2001-280. For a more detailed discussion of this case, see \$ 15.05[5] infra.
a married couple’s mining company, an S corporation, to their farming operation, also an S corporation, increased their basis in the farming S corporation. The Tax Court, again relying upon the incorporated pocketbook theory, concluded that Mr. Yates simply skipped the steps of having the mining company S corporation transfer such funds to him, and then having him transfer such funds to his farming S corporation.

[5] Shareholder Must Make an Actual Economic Outlay

The requirement that an S corporation shareholder make an actual economic outlay in order to receive a basis increase for indebtedness of the S corporation to the shareholder is based upon the language of the Senate Finance Committee Report accompanying the predecessor to § 1366(d) which provides that a shareholder’s proportionate share of the S corporation’s losses be limited to the adjusted basis of the shareholder’s “investment” in the S corporation.

The courts construing this requirement have held that in order for indebtedness of an S corporation to its shareholder to be comparable to an actual capital investment by the shareholder, an actual economic outlay must be made by the shareholder such that the shareholder is poorer in a material sense after the transaction than he was before the transaction began.

In addition to there being questionable authority for the application of the actual economic outlay theory to the loan structuring and restructuring area, the IRS and the courts have not clearly defined what constitutes an actual economic outlay in the loan restructuring area. An examination of the various cases and rulings applying the actual economic outlay requirement in other areas, however, is helpful in determining the manner in which the requirement should be applied (if at all) in the loan restructuring area.

[a] Guarantees

A substantial amount of litigation has involved the issue of whether an S corporation shareholder should be allowed to increase his basis by the amount of corporate-level indebtedness personally guaranteed by such shareholder.

In Estate of Leavitt v. Commissioner,26 the Fourth Circuit held that a

24 See text accompanying note 15 supra.
Both the Fifth Circuit in *Harris v. United States*,\(^29\) and the Tenth Circuit in *Goatcher v. Commissioner*,\(^30\) and *Uri v. Commissioner*,\(^31\) have followed the Fourth Circuit’s decision in *Leavitt*, in holding that S corporation shareholders are *not* entitled to increase the basis of their S corporation stock by the amount of corporate-level indebtedness that they have personally guaranteed.\(^32\)

Consequently, except for the Eleventh Circuit’s decision in *Selfe*, the courts have uniformly held that absent an *actual payment* of a corporate-level debt personally guaranteed by the shareholder of an S corporation, such shareholder may *not* increase his basis in the S corporation within the meaning of § 1366(d)(1)(B).

[b] Contribution of Notes

The IRS and the courts have held that the execution of a promissory note by a shareholder payable to his S corporation is not an actual economic outlay that will enable the shareholder to increase his basis in the S corporation within the meaning of § 1366(d)(1)(B).

In Revenue Ruling 81-187,\(^33\) the IRS ruled that an S corporation shareholder was not entitled to a basis increase where the shareholder executed an unsecured demand promissory note in favor of his wholly-owned S corporation and transferred the promissory note to the corporation. The IRS concluded that since the shareholder incurred no cost in executing the promissory note, the shareholder’s basis in the note was zero, and, as such, the shareholder had made no actual economic outlay.

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\(^29\) 902 F.2d 439 (5th Cir. 1990).

\(^30\) 944 F.2d 747 (10th Cir. 1991).

\(^31\) 949 F.2d 371 (10th Cir. 1991).

\(^32\) In a number of other cases (see generally *Shaver v. Commissioner*, T.C. Memo 1993-619; *Doe v. Commissioner*, T.C. Memo 1993-583; *Ley v. Commissioner*, T.C. Memo 1993-306; *Nigh v. Commissioner*, T.C. Memo 1990-349; *Russell v. Commissioner*, T.C. Memo 1990-217; *Fear v. Commissioner*, T.C. Memo 1989-211; and *Rosch v. Commissioner*, T.C. Memo 1989-158), the Tax Court has followed the *Leavitt* decision, even where: the shareholders signed as co-makers rather than as guarantors on promissory notes (see *Keech v. Commissioner*, T.C. Memo 1993-71 and *Erwin v. Commissioner*, T.C. Memo 1989-80) new consolidation notes were executed in place of prior notes that had been personally guaranteed by the shareholders (see *Ellis v. Commissioner*, T.C. Memo 1989-280), the S corporation was liquidated and the indebtedness was assumed in liquidation by the shareholder (*Suisman v. Commissioner*, T.C. Memo 1989-629), and the shareholder’s personal guarantee was secured by a pledge of his personal assets (see *Allen v. Commissioner*, T.C. Memo 1993-612).


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In *Silverstein v. United States*,\(^34\) the court held that shareholders were not entitled to a basis increase where they gave their own promissory notes to an S corporation for stock which was issued in the same proportion as their previous stock ownership in the corporation. Although the court reasoned that a shareholder does not always need to make an *immediate* economic outlay to meet the actual economic outlay requirement, the shareholders’ exchange of their own promissory notes for new stock of the S corporation issued in the same proportions as held by them prior to the transaction was a sham transaction and therefore the promissory notes did not create a real economic liability.

In *Perry v. Commissioner*,\(^35\) the Tax Court held that a shareholder was not entitled to a basis increase where the shareholder exchanged his own demand notes for the S corporation’s long-term notes payable to the shareholder. The court stated that “in the absence of an actual loan of money or other reliable consideration,” no indebtedness of the S corporation to the shareholder within the meaning of § 1366(d)(1)(B) can be created. Since there was no actual transfer of funds to the S corporation by the shareholder, the court concluded that the transaction was no more than a bookkeeping maneuver, and therefore the shareholder was not entitled to increase his basis in the S corporation.

Although the authorities cited above reach the same result, no less than three different theories were employed to reach the conclusion that the contribution of a shareholder’s own promissory note to an S corporation does not constitute an actual economic outlay by the shareholder within the meaning of § 1366(d)(1). In Revenue Ruling 81-187, the IRS found that no basis increase was justified since the shareholder had a zero basis in the promissory note and such basis carried over to the S corporation. In *Silverstein*, the court denied a basis increase on the contribution of the shareholder’s note to the S corporation in exchange for stock because it determined the transaction was a sham transaction lacking economic substance. Finally, in *Perry*, the court concluded that the shareholder was not entitled to a basis increase since he had not made an actual transfer of funds to the S corporation. Consequently, while consistent in result, the IRS and the courts have employed different theories as to what constitutes an actual economic outlay in this context.

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\(^35\) 54 T.C. 1293 (1970), aff’d, 51-2 U.S.T.C. (CCH) ¶ 9502 (8th Cir. 1971).
In *Borg v. Commissioner*, the Tax Court held that a shareholder could not increase his basis in the S corporation where the corporation executed a demand note in favor of the shareholder for past salaries owed by the corporation to the shareholder. In determining whether the shareholder had an adjusted basis in the corporation’s promissory note, the court focused on the general provisions of the Code concerning basis, namely § 1012. The court found that since the shareholder had previously been taxed on the amounts owed by the corporation to him, he would have a tax cost basis in such indebtedness, and the Tax Court would have apparently permitted the shareholder to increase his basis in the S corporation. Thus, if an S corporation shareholder has obtained a “tax cost” basis in a promissory note in some manner, he should be entitled to increase his basis under § 1366(d)(1)(B).

A shareholder’s contribution (or loan) to an S corporation of funds that were borrowed from a third party should satisfy the actual economic outlay test. If the shareholder in *Borg* had previously been taxed on the amounts owed by the corporation to him, he would have a tax cost basis in such indebtedness, and the Tax Court would have apparently permitted the shareholder to increase his basis in the S corporation. Thus, if an S corporation shareholder has obtained a “tax cost” basis in a promissory note in some manner, he should be entitled to increase his basis under § 1366(d)(1)(B).

The cases and rulings applying the actual economic outlay requirement indicate that the determination of whether a shareholder has made an actual economic outlay sufficient to create indebtedness of the S corporation to such shareholder under § 1366(d)(1)(B) depends upon the facts and circumstances of the situation. In the guarantee area, only an actual payment pursuant to the personal guarantee will constitute an actual economic outlay sufficient to create indebtedness of the S corporation to the shareholder. In cases in which a shareholder contributes his own promissory note to the S corporation, the cases and rulings have held that no actual economic outlay occurs under a variety of theories. *Borg* suggests that even in the absence of an actual transfer of funds to an S corporation, an S corporation shareholder may meet the actual economic outlay requirement if the shareholder has a cost basis in the indebtedness of the S corporation. Moreover, the actual economic outlay requirement is also met where a shareholder contributes funds from a third party and then contributes or loans such funds directly to the S corporation, since there is an actual transfer of funds to the S corporation in such a situation.

Although it is far from clear under what authority the actual economic outlay is being applied in the back-to-back loan area, the cases and rulings outside the loan restructuring area have established only two methods by which a shareholder can meet the actual economic outlay requirement. First, the shareholder can meet such requirement by actually transferring funds to the S corporation. Second, the cases and rulings suggest that a shareholder may also meet the actual economic requirement if he has a basis in the indebtedness of the S corporation under general principles of tax law.

**[1] Factual Pattern In Loan Restructurings**

The common denominator in all loan restructuring is, of course, that the

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26 50 T.C. 257 (1968).
27 See § 15.06[2] *infra* for a discussion of a situation where a tax-cost basis in indebtedness of an S corporation should result in an increase in the shareholder’s basis in the S corporation under § 1366(d)(1)(B).
28 See generally Gurda v. Commissioner (shareholders’ basis in S corporation was increased where they borrowed funds from a bank and then loaned such funds to their S corporation); and Letter Ruling 8747013 (shareholders’ basis in S corporation was increased where they borrowed funds from a bank, lent the proceeds to their S corporation, which then repaid its existing loan from such bank).
29 T.C. Memo 1975-113, rev’d on another issue, 540 F.2d 184 (3rd Cir. 1976).
original loan transaction was structured in a manner that did not create indebtedness of the S corporation to the shareholder within the meaning of § 1366(d)(1)(B). The shareholder and his tax advisor are in the position of determining how to restructure the loan to enable the shareholder to increase his basis. Typically, the situation involves a loan that was originally made directly from a third party to the S corporation and was personally guaranteed by the shareholder. The IRS and the courts have permitted S corporation shareholders to increase their basis in some circumstances, while denying S corporation shareholders a basis increase in other nearly identical circumstances. Thus, an examination of the particular facts and circumstances is necessary in order to determine how a shareholder can successfully restructure a loan transaction to increase his basis in the S corporation.

[2] Loan Restructurings Resulting in Basis Increase

The one constant in every situation where a shareholder has been permitted to increase his basis in an S corporation in connection with a loan restructuring is that the transaction originally involved a loan from an unrelated third-party lender.

In Revenue Ruling 75-144, a loan was made by a third-party bank directly to an S corporation, and was personally guaranteed by the sole shareholder of the S corporation. The shareholder subsequently substituted his own personal promissory note for the corporation’s promissory note to the third-party bank, which then released the corporation’s promissory note from liability. The IRS concluded that the substitution of the shareholder’s personal promissory note, together with the acceptance of the shareholder’s personal promissory note by the bank and the bank’s release of the S corporation’s promissory note to the third-party bank, caused the indebtedness of the S corporation to accrue to the shareholder. Consequently, the shareholder was permitted to increase his basis in the S corporation by the amount of such indebtedness.

Similarly, in Gilday, the Tax Court held that shareholders acquired basis in their S corporation when they substituted their personal promissory notes for the S corporation’s promissory note to a third-party bank. Again, the third-party bank released the corporation and the corporation then issued a promissory note to its shareholders.

In Letter Ruling 8747013, the IRS once again granted a basis increase to shareholders in connection with the restructuring of a loan to their S corporation. Unlike Revenue Ruling 75-144 and Gilday, however, the shareholders did not “substitute” their own personal promissory notes for the S corporation’s promissory note to the third-party bank. Rather, the loan was restructured by having the shareholders personally borrow the funds directly from the bank, who then loaned such funds to the S corporation, which then used the funds to satisfy its indebtedness to the third-party bank.

The results reached in Revenue Ruling 75-144 and Gilday are difficult to reconcile with the actual economic outlay requirement as developed by the IRS and the courts. Where a shareholder merely substitutes his own personal promissory note for the S corporation’s promissory note which the shareholder had personally guaranteed, there are no actual funds flowing from the shareholder to the S corporation. In this situation, shareholders are being allowed to increase their basis in the S corporation even though they have made no current economic outlay.40

Revenue Ruling 75-144 and Gilday can only be reconciled with the actual economic outlay requirement by assuming that the IRS and the courts are applying a legal fiction that results in the shareholder making an actual economic outlay. For example, where a shareholder substitutes his own personal promissory note for the S corporation’s promissory note to a third-party lender, the shareholder could be viewed as borrowing the cash from the third-party lender in exchange for his personal promissory note, transferring such funds to the corporation as either a loan or a contribution, with the corporation then using such funds to satisfy its promissory note to the lender. This is precisely the manner in which the loan was actually restructured in Letter Ruling 8747013. Alternatively, the shareholder could be viewed as purchasing the corporation’s promissory note from the third-party lender in exchange for the shareholder’s own promissory note, which would result in the shareholder receiving a cost basis in the S corporation’s promissory note under § 1012. In any event, if the actual economic outlay requirement is met at all in situations such as those presented in Revenue Ruling 75-144 and Gilday, it is being satisfied without an actual transfer of funds by the shareholder to the S corporation, and without the shareholder actually having a cost basis in the indebtedness of the S corporation.

In Letter Rulings 9811016, 9811017, 9811018 and 9811019, the IRS ruled that a restructured loan from the shareholders of an S corporation to the S corporation

40 This is similar to the situation where a taxpayer purchases stock from an existing shareholder of an S corporation in exchange for the taxpayer’s promissory note. Although the taxpayer makes no current economic outlay, he is permitted to increase his basis in the S corporation. In these situations, an immediate basis increase is given to the shareholder, possibly because the law is presuming that an independent creditor will require the taxpayer to make an economic outlay in the future. See J. Eustice & J. Kuntz, Federal Income Taxation of S Corporations at ¶ 9.05[2][i] n. 350 (Warren Gorham & Lamont, 4th ed. 2001).
constituted “indebtedness of the S corporation to the shareholders” within the meaning of § 1366(d)(1)(B), where the loan was originally made by a third-party bank directly to the S corporation rather than to the shareholders.

In Miller v. Commissioner,41 the Tax Court held that the shareholder of an S corporation was entitled to increase his basis in the indebtedness of the S corporation under § 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.

[3] Loan Restructurings Not Resulting in Basis Increase

The one constant in every situation where a shareholder has not been allowed to increase his basis in an S corporation in connection with a loan restructuring is that the transaction originally involved a loan from an entity controlled by the shareholder.

In TAM 9403003, the IRS ruled that 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 § 1366(d)(1)(B) where the loan originally had been structured as a loan from another S corporation controlled by the shareholder to the shareholder’s wholly-owned S corporation.42 Similarly, the Tax Court has denied S corporation shareholders basis increases in connection with loan restructurings where the loans were originally made by related corporations. Each of the cases discussed below was cited by the IRS in TAM 9403003 in support of its position that shareholders should not be entitled to increase their basis in an S corporation in connection with the restructuring of a loan between related entities.

In Underwood v. Commissioner,43 the court held that the shareholders of an S corporation would not be entitled to increase their basis where they substituted their own personal promissory notes for the promissory notes that their S corporation had previously executed in favor of another corporation that was wholly-owned by the same shareholders. The sole distinction between the situation presented in Underwood and the situations presented in Revenue Ruling 75-144 and Gilday (where the shareholders were permitted to increase their basis in the S corporation), is that the original loan in Underwood was made by a corporation that was wholly-owned by the shareholders, whereas in Revenue Ruling 75-144 and Gilday the original loan was made by an unrelated third-party bank. Just as in Revenue Ruling 75-144 and Gilday, there was no actual transfer of funds by the shareholders to the S corporation; rather, there was merely a substitution of promissory notes. Despite these similarities, the Tax Court nevertheless concluded that the shareholders had not made an actual economic outlay that would permit them to increase their basis in the S corporation under § 1366(d)(1)(B). In reaching its decision, the court specifically distinguished Revenue Ruling 75-144 on the basis that the obligee on the shareholder’s note in Revenue Ruling 75-144 was an unrelated bank which stood ready to enforce the obligation, whereas, the obligee on the shareholders’ promissory notes in Underwood was their own wholly-owned corporation and it was not clear that the shareholders would ever make a demand upon themselves for the payment of such promissory notes.

In Shebester v. Commissioner,44 the Tax Court held that a shareholder’s assumption of a promissory note payable by one controlled S corporation to another controlled S corporation would not result in the creation of indebtedness of the S corporation to the shareholder so as to permit the shareholder to increase his basis in the S corporation. The court, citing Underwood, concluded that the loan restructuring did not reflect a current economic outlay entitling the shareholder to increase his basis in the S corporation.

In Griffith v. Commissioner,45 the Tax Court held that an S corporation shareholder was not entitled to a basis increase where journal entries reflected the assumption of a loan between related S corporations by the shareholder. Applying the guarantee line of cases, the court concluded that in order for a shareholder to have made an actual economic outlay in this context, the shareholder must have actually paid out monies on behalf of, or advanced funds to, the S corporation. Additionally, the court again distinguished Revenue Ruling 75-144 and Gilday on

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41 See § 15.05[3] infra for a more detailed discussion of these rulings.
43 It would be interesting to know whether the IRS would have taken the same position had the shareholder borrowed funds from one controlled S corporation and then re-loaned those same amounts to another controlled S corporation. Under the reasoning used by the IRS to reach its conclusions in TAM 9403003, it would appear that the taxpayer would not be entitled to increase his basis in the S corporation even if the transaction originally had been structured in this manner. Perhaps this question has been answered in TAM 200619021. See § 15.05[11] infra.
44 63 T.C. 468 (1975), aff'd, 535 F.2d 309 (5th Cir. 1976).
45 T.C. Memo 1987-246.
the basis that the obligee on the shareholder's promissory note was another corporation controlled by the shareholder rather than a third-party bank. Interestingly, however, the court indicated that if sufficient evidence had been presented to establish that the advanced funds had come from previously-taxed income, the shareholder might have been entitled to increase his basis in the S corporation. Presumably, if the funds previously had been taxed, the shareholder would have had a tax cost basis in such amounts, and therefore be entitled to increase his basis in the S corporation to the extent of his adjusted basis in the indebtedness.

In a variation on a common loan restructuring theme, the Tax Court in Wilson v. Commissioner, 47 held that the shareholders of two S corporations could not increase their respective bases in the S corporations by the amount of loans distributed to the shareholders from a third S corporation controlled by them which had previously made the loans to the two S corporations. The court concluded that the distributed loans did not represent indebtedness for purposes of determining the shareholders' bases in the stock and indebtedness of the two S corporations since the shareholders made no actual economic outlay with respect to such loans. Specifically, the court found that even though the shareholders had reported the receipt of the loans on their individual federal income tax returns, the distribution of the loans to them by their controlled S corporation did not constitute an actual economic outlay sufficient to create indebtedness of the S corporation to the shareholders within the meaning of § 1366(d)(1)(B).

In Thomas v. Commissioner, 48 the Tax Court held that the taxpayer's basis in each of two S corporations was not increased as a result of loans made by various other entities controlled by the taxpayer to the two S corporations.

In Oren v. Commissioner, 49 the Eighth Circuit Court of Appeals held that amounts loaned to two S corporations by their sole shareholder did not create "indebtedness of the S corporation to the shareholder" within the meaning of § 1366(d)(1)(B) so as to permit the shareholder to increase his basis in the S corporations, where the source of the loaned funds was another S corporation controlled by the shareholder.

In Kaplan v. Commissioner, 50 the Tax Court held that the amounts loaned by a shareholder to his wholly owned S corporation did not constitute "indebtedness of

48 T.C. Memo 2002-108. For a more detailed discussion of Thomas, see § 15.05[7] infra.
49 T.C. Memo 2002-172. For a more detailed discussion of Oren, see § 15.05[6] infra.
50 T.C. Memo 2005-217. For a more detailed discussion of Kaplan, see § 15.05[8] infra.

the S corporation to the shareholder" within the meaning of § 1366(d)(1)(B), where the S corporation used the loan proceeds to pay off debts to other related S corporations.

In Ruckriegel v. Commissioner, 51 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 § 1366(d)(1)(B).

§ 15.05 CASES AND RULINGS ADDRESSING S CORPORATION BASIS INCREASES SINCE TAM 9403003 (OTHER THAN BERGMAN)

[1] Hitchins v. Commissioner

In Hitchins v. Commissioner, 52 the Tax Court, in a case of first impression, held that a loan originally made by a shareholder to his controlled C corporation that was assumed by an S corporation in which the shareholder and his wife were 50% shareholders, did not constitute "indebtedness of the S corporation to the shareholder" within the meaning of § 1366(d)(1)(B). Consequently, the shareholder was not permitted to increase his basis in the S corporation and was therefore unable to deduct losses incurred by the S corporation during the taxable year.

Under the facts of Hitchins, a C corporation (C) controlled by shareholder and his wife borrowed $34,000 from shareholder to pay certain operating expenses. An S corporation (S) in which shareholder and his wife owned a 50% interest was subsequently billed by C for the expenses incurred by C relating to the development of a chemical data base for S. S initially paid the invoice by issuing a promissory note to C, which S subsequently satisfied by payment of cash and its agreement to pay C's $34,000 liability to shareholder. C was not, however, relieved of its liability to shareholder nor was any note executed between S and the shareholder.

Although the Tax Court found that shareholder had made an economic outlay, and that by virtue of the assumption, S became obligated to pay the $34,000 to shareholder, it concluded that since there was no direct obligation from S to
shareholder, shareholder was simply a creditor-beneficiary of S whose rights against S were derivative through C, and as such, the loan did not constitute indebtedness of the S corporation to shareholder within the meaning of § 1366(d)(1)(B). The court found it significant that as between C and S, C remained liable as a surety of the obligation of S to shareholder. Consequently, the court concluded that there was no investment by shareholder in S as contemplated under § 1366(d)(1)(B). The court distinguished Gilday and Revenue Ruling 75-144 (in which shareholders were granted an increase in basis where they substituted their personal notes for the S corporation’s note to a third-party bank), since C remained liable on the note to shareholder whereas the S corporations in Gilday and Revenue Ruling 75-144 were released of liability on their notes to the third-party banks.

The most interesting aspect of Hitchins is that the court went on to state that if C had been released from liability by a novation and a replacement note had been issued by S to shareholder, or alternatively, if shareholder loaned $34,000 to S, followed by S’s payment of its debt to C, and C’s repayment of the loan to S (a circular flow of funds), shareholder may well have been able to increase his basis in S under § 1366(d)(1)(B). In effect, the court suggested that if the taxpayer had taken the steps taken by the taxpayer in TAM 9403003, the taxpayer could have documented, should result in a basis increase for the S corporation shareholder. Consequently, the opinion in Hitchins is that the court went on to state that if C had been released from liability by a novation and a replacement note had been issued by S to shareholder, or alternatively, if shareholder loaned $34,000 to S, followed by S’s payment of its debt to C, and C’s repayment of the loan to S (a circular flow of funds), shareholder may well have been able to increase his basis in S under § 1366(d)(1)(B). In effect, the court suggested that if the taxpayer had taken the steps taken by the taxpayer in TAM 9403003, the taxpayer could have increased his basis in the S corporation (contrary to the result reached by the IRS in TAM 9403003).


In Bhatia v. Commissioner, the Tax Court held that the sole shareholder of an S corporation was not entitled to increase his basis in the S corporation by reason of his assumption of the S corporation’s indebtedness to another corporation which was also wholly owned by the shareholder. Consequently, the shareholder was unable to deduct the losses incurred by the S corporation during the taxable year.

Under the facts of Bhatia, the taxpayer was the sole shareholder of two S corporations (ABDC and GCC). ABDC owed approximately $244,500 to GCC. In order to enable the shareholder to deduct the losses which were being incurred by ABDC, the shareholder entered into an "Assumption Agreement" with ABDC and GCC pursuant to which the shareholder assumed ABDC’s liability to pay the $244,500 indebtedness to GCC. The Assumption Agreement also provided that the assumption would be considered as a valid obligation of ABDC to the sole shareholder in the amount of the obligation assumed. The shareholder did not, however, present any evidence that any promissory notes were issued, collateral pledged, or interest rate or repayment schedule established, and no payments were ever made by the shareholder to GCC pursuant to the Assumption Agreement.

The Tax Court, citing the Underwood and Hitchins cases, concluded that the sole shareholder’s assumption of ABDC’s indebtedness to GCC did not constitute an “actual economic outlay” as required by law, and as such, the sole shareholder was not entitled to increase his basis by the amount of indebtedness assumed pursuant to the Assumption Agreement. Additionally, the Tax Court distinguished Revenue Ruling 75-144 (in which a shareholder was granted an increase in basis with respect to a similar loan restructuring), since the obligee on the shareholder’s note in that situation was an unrelated third-party bank rather than a corporation controlled by the shareholder.

Although the Tax Court rejected the taxpayer’s argument, the court recognized that the decided cases did place a heavy burden on shareholders who seek to rearrange the indebtedness of related closely held S corporations. The court additionally provided that the existence of such a relationship is not necessarily fatal if other elements are present which clearly establish the bona fides of the transaction and their economic impact, and specifically cited: (1) Hitchins (in which the Tax Court set forth alternative methods by which the shareholder in that case could have obtained a basis increase), and (2) Looney, “TAM 9403003: The Service’s Not-So-Kind-And-Gentle Approach to Loan Restructurings Between Related Entities,” 6 J. S Corp. Tax’n 297 (Spring 1995), as support for the position that loan restructurings between related entities, if properly structured and documented, should result in a basis increase for the S corporation shareholder. Consequently, the opinion in Bhatia seems to suggest that the Tax Court will be willing in the future to increase a shareholder’s basis in an S corporation in connection with a loan restructuring between related entities where adequate evidence is presented to establish a bona fide transaction.


In these related rulings, the IRS ruled that a restructured loan from the shareholders of an S corporation to the S corporation constituted “indebtedness of the S corporation to the shareholders” within the meaning of § 1366(d)(1)(B), even though the loan was originally made by a third-party bank directly to the S corporation rather than to the shareholders.

Under the facts of the rulings, an S corporation had an outstanding liability evidenced by a note issued by the corporation to an unrelated third-party bank.
The shareholders also had signed as co-makers on the bank note. Pursuant to a proposed loan restructuring, the shareholders will give the bank their personal notes and the bank will then cancel the S corporation’s note to the bank. In exchange for relief of its indebtedness to the bank, the S corporation will then issue promissory notes directly to its shareholders.

The IRS, citing Gilday and Revenue Ruling 75-144, concluded that the shareholders of the S corporation would be permitted to increase their basis in the S corporation by the amount of the restructured indebtedness pursuant to § 1366(d)(1)(B).

Letter Rulings 9811016-9811019 are consistent with the IRS’s prior position in the loan restructuring area. As discussed above, although the IRS has generally not permitted shareholders to increase their basis in an S corporation in connection with loan restructurings originally involving a loan from an entity controlled by the shareholder, the IRS has consistently allowed shareholders to increase their basis in an S corporation in connection with loan restructurings originally involving a loan from an unrelated third-party lender, such as the loans involved in Letter Rulings 9811016-9811019.

4 Culnen v Commissioner

In Culnen v Commissioner, the Tax Court held that amounts transferred by the taxpayer-shareholder’s wholly-owned C corporation (Culnen & Hamilton) to an S corporation (Wedgewood) in which the taxpayer-shareholder held varying interests during the years in issue, and payments made by Culnen & Hamilton in payment of expenses of Wedgewood, constituted “indebtedness of the S corporation to the shareholder” within the meaning of § 1366(d)(1)(B). As such, the taxpayer-shareholder was entitled to increase his basis in Wedgewood by such amounts and therefore able to deduct the losses incurred by Wedgewood during the tax years in issue.

The Tax Court first found that the direct payments by Culnen & Hamilton to Wedgewood did not preclude such amounts from being treated as loans by Culnen & Hamilton to the taxpayer-shareholder, and then loaned from the taxpayer-shareholder to Wedgewood. The Tax Court stated that the statutory requirement under § 1366(d)(1)(B) that the indebtedness of the S corporation run directly to the shareholder is not satisfied where the indebtedness of the S corporation is to an entity with pass-through characteristics that has advanced such funds to the S corporation and is closely related to the taxpayer. However, the Tax Court stated that the fact that the borrowed funds originate with a closely held entity does not necessarily preclude the indebtedness of the S corporation from running directly to the shareholder. The Tax Court continued that where there is a close relationship among the S corporation, the taxpayer, and the related entity, it will scrutinize relationships established with respect to the transfer of funds to ensure that those relationships comport with the statutory requirement prescribed under § 1366(d)(1)(B). The Tax Court also distinguished Underwood v Commissioner, stating that it stood for the proposition that a shareholder who merely guarantees an S corporation indebtedness cannot increase his basis by such amount under § 1366(d)(1)(B), and that was simply not the situation presented in Culnen.

The taxpayer called four witnesses, including himself, all of whom consistently testified that for many years (including the years in issue), the taxpayer-shareholder had used Culnen & Hamilton as an “incorporated pocketbook,” having the corporation make payments on his behalf, which payments were posted to Culnen & Hamilton’s books as loans to the taxpayer. The Tax Court found this evidence persuasive, and found the IRS’s claim that the witness’s testimony should be disregarded because it was “unsupported” as unpersuasive. In fact, the Tax Court stated that the IRS’s only evidence was its unsupported attacks on the taxpayer-shareholder’s witnesses, and that its resort to “name-calling” was not an acceptable fallback position and stated that it expressly disapproved of such tactics.

5 Yates v Commissioner

In Yates v Commissioner, the Tax Court held that various transfers made by a married couple from their mining company (Adena), an S corporation, to their farming operation (FoxTrot), an S corporation, increased their basis in FoxTrot. Additionally, the Tax Court held that transfers in the form of capital contributions from Adena to FoxTrot before the husband gave all of his shares of FoxTrot to his wife, constituted transfers from the husband to FoxTrot, which increased his basis in FoxTrot. The Tax Court also found that FoxTrot incurred indebtedness to the husband, which increased his basis in FoxTrot.

The Tax Court, contrary to its position in a number of prior cases, held that the husband could increase his basis in FoxTrot as a result of the funds transferred

54 T.C. Memo 2000-139.

55 63 T.C. 468 (1975), aff’d, 535 F.2d 309 (5th Cir. 1976).

56 T.C. Memo 2001-280.
from Adena to FoxTrot while he was the sole shareholder of FoxTrot. Additionally, the Tax Court concluded that the "uncontradicted and credible testimony" of Mr. Yates established that Mr. Yates made gifts to Mrs. Yates of the subsequent transfers from Adena to FoxTrot, which increased her basis in FoxTrot. The court noted that Mr. Yates simply skipped the steps of having Adena transfer such funds to him, depositing the funds in Mr. and Mrs. Yates' joint account, and then having Mrs. Yates write a check to FoxTrot. In support of its decision, the Tax Court cited its prior decision in Culnen, where the court allowed an S corporation shareholder to increase his basis under similar circumstances.


In Oren v. Commissioner, the Eighth Circuit Court of Appeals held that amounts loaned to two S corporations by their sole shareholder did not create "indebtedness of the S corporation to the shareholder" within the meaning of § 1366(d)(1)(B) so as to permit the shareholder to increase his basis in the S corporations, where the source of the loaned funds was another S corporation controlled by the shareholder. As such, the shareholder was not able to deduct the substantial losses that had been incurred by his wholly owned S corporations.

The shareholder in Oren owned stock in several S corporations which were engaged in different facets of the trucking business. The taxpayer owned a controlling interest in Dart Transit Company (Dart), an S corporation engaged in the "high service just-in-time" segment of the truck load carrier industry. The taxpayer also owned all of the stock of two other S corporations, Highway Leasing (HL), which was engaged in leasing trailers to Dart and other parties, and Highway Sales (HS), which purchased tractors and then leased them under a "lease-to-purchase" program to individuals who wanted to become owner-operators of the tractors.

During the years in issue, it became clear that both HL and HS would generate substantial losses which the taxpayer would be unable to deduct as a result of the basis limitation rules of § 1366(d). The taxpayer was advised by his tax advisers to "restructure" his financial investments in his various companies so as to increase his basis in HL and HS and permit him to receive the benefit of the ordinary loss deductions generated by those corporations. Pursuant to a series of lending transactions entered into for the purpose of increasing the taxpayer's bases in HL and HS, Dart loaned substantial sums of money (which it obtained under its line of credit with First Bank National Association) to the taxpayer-shareholder, who in turn loaned such funds to HL and HS, with HL or HS, as the case may be, then loaning such funds back to Dart. With respect to each of the loans, a note was executed providing that principal would be due 375 days following demand, and interest accrued (and was due) annually at a 7% rate. The proceeds of each loan were distributed in the form of a check drawn on the lender's bank account and deposited in the borrower's bank account. In this manner, the taxpayer-shareholder attempted to create sufficient basis to allow him to deduct the substantial losses incurred by HL and HS during the tax years in issue.

In affirming the Tax Court's decision that the shareholder was not entitled to increase his basis in HL and HS as the result of the loans he made to those corporations, the Eighth Circuit relied on the so-called "actual economic outlay" doctrine, finding that a shareholder's basis in an S corporation will be increased by a loan from a shareholder to the S corporation only if that shareholder has made an actual economic outlay. The court also found that the actual economic outlay must leave the taxpayer "poorer in a material sense" after the transaction than he was before the transaction began. Specifically, the Eighth Circuit stated the following:

Only where the shareholder provides his own money (or money he is directly liable for) to the S corporation, will basis increase. So, a shareholder who borrows money in an arm's-length transaction and then loans the funds to the S corporation, is entitled to an increase in basis.

Although the court acknowledged that Oren and his corporations observed all the formalities necessary to create legal obligations (signed promissory notes, checks issued and cashed, interest payments made), the court concluded that "there were no arm's-length elements in the transactions. No external parties were involved." The court found that for an event to have a direct effect on the taxpayer, Dart would have had to choose to enforce the taxpayer's obligation to it, a decision that would have been made by the taxpayer, who controlled all voting shares in Dart. Finally, the court stated that taxpayer "would suffer no additional loss (over his previous investments), as the result of the loans, by a simple decline in the value of any of the corporations." As such, the court concluded that the taxpayer's loans were not actual economic outlays and that he was in the same position after the transaction as before, and as such, he was not entitled to a basis increase in his shares of stock of HL and HS.

In its opinion in Oren, the Eighth Circuit specifically stated that a shareholder who borrows money in an arm's-length transaction and then loans the funds to an
S corporation is entitled to an increase in basis. There was absolutely no evidence
presented in the Oren case which suggested that the funds were not borrowed by
the taxpayer in an arm’s-length transaction (i.e., the loans were properly
documented by executed promissory notes, checks were drawn, interest was paid,
etc.). Again, the court simply arrived at the conclusion that the loans were not
“arm’s-length” based solely on the fact that the loans were between related parties
and no external parties were involved. Additionally, the Eighth Circuit notes in its
decision that the taxpayer would suffer no additional loss (over his previous
investments) as a result of the loans, by a simple decline in the value of any of the
corporations. This statement is simply incorrect. The taxpayer has indeed put a
substantial amount of money that was not previously subject to the creditors of
HL and HS, at risk with respect to the claims of the creditors of HL and HS by
transferring those funds to HL and HS. In the event of claims made on the assets
of HL and HS by third-party creditors, the taxpayer clearly would be left poorer
in a material sense since the creditors would be able to reach assets that they
would not have otherwise been able to reach as a result of the loan restructur-
ing, and the shareholder would suffer a real economic loss as a result of the loan
restructuring.58


In Thomas v. Commissioner,59 the Tax Court held that the taxpayer’s basis in
each of two S corporations (RAM and Intrusion) was not increased as a result of
loans made by various other entities controlled by the taxpayer to the two S
corporations.

Under the facts of Thomas, various entities controlled by the taxpayer made
direct loans to RAM and Intrusion, which were initially reflected on the books of
the controlled corporations, RAM and Intrusion, as loans payable and loans
receivable directly between such companies. Subsequently, such amounts were
reclassified as loans from the controlled corporations to the shareholder, and then

58 For example, assume that Dart has a net worth of $1,000,000, and that HL has net assets of
$300,000 prior to any loan restructuring. Dart loans $200,000 to Mr. Oren who then 
loans $200,000 to HL, with HL loaning the $200,000 received from Mr. Oren back to Dart. If there are 
claims by third-party creditors against HL for $500,000, the creditors would be able to recover the full amount 
of the claims from HL based on HL’s net assets of $300,000 and the $200,000 note receivable from 
Dart. If the loan restructuring had never occurred, all the creditors would have been able to recover from 
HL, would be the $300,000 of HL’s net assets. Most certainly, Mr. Oren is $200,000 poorer 
than he would have been had he never entered into the loan restructuring transaction.

59 T.C. Memo 2002-108.

as loans by the taxpayer-shareholder to RAM and Intrusion (and later as additional
paid-in capital to RAM and Intrusion rather than as loans).

The Tax Court cited Culnen and Yates for the proposition that, in limited
situations, the fact that borrowed funds originate with a closely-held entity will
not preclude a finding that the indebtedness of the S corporation runs directly to
the shareholder and amounts to an economic outlay by the shareholder. The court
emphasized that in cases where the shareholder claims basis in an S corporation
for funds initially advanced by a related entity, the court will closely scrutinize the
facts surrounding the transfer of funds to establish a relationship that allows the
shareholder to satisfy the requirements for a basis increase. Based on these
principles, the Tax Court examined each of the advances made by the taxpayer’s
related entities to his S corporations, and found in each case that the controlled
entities were not acting as an agent of the shareholder in disbursing funds to the
S corporation on his behalf. Rather, the court found that the related corporations
were the true lenders (acting on their own behalf) as evidenced by the fact that the
transactions were initially booked as loans directly from the related entities to the
S corporations, rather than as loans from the related entities to the shareholder
and then as loans from the shareholder to the S corporations. Consequently, the court
concluded that the amounts advanced to the corporations by the related entities
did not meet the requirements of § 1366(d)(1)(B), and as such, the shareholder
would not be allowed to increase his bases in the S corporations as a result of such
advances.


In Kaplan v. Commissioner,60 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 § 1366(d)(1)(B), and
as such, did not increase his basis in the S corporation by the amount of such
indebtedness.

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 Develop-
ment, 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

60 T.C. Memo 2005-217.
could not be deducted by the taxpayer under § 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 and Bergman, 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.

[9] Ruckriegel v. Commissioner

In Ruckriegel v. Commissioner, 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 § 1366(d)(1)(B).

The case 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 his own funds, 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 Treas. 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

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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 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 [the partnership to the S corporation] as without legal significance, in this instance petitioners’ involvement, at some personal inconve-


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

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 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 corporation 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 collateralized 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 Collaterally assigned to the bank as security for the loan (security for the loan) in favor of the shareholder, which the shareholder in turn executed a promissory note and a security agreement (pledging its assets as security for the loan). 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 has not made any payments to the Rapp Group to reimburse them for payments to satisfy the loan pursuant to their guarantees, nor has the Rapp Group sought reimbursement from the shareholder.

The shareholder increased his basis in the S corporation as a result of the loan restructuring, and consequently 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, then the payment to the bank by the Rapp Group under its guarantee constituted taxable forgiveness of debt income to the shareholder under § 108.

Although the Tax Court allowed the shareholder to increase his basis as the 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 § 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 § 465(b)(4).

Finally, the court concluded that although the shareholder did realize discharge 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 § 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 which 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 Letter Ruling 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, 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 courts' 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.


In TAM 2006/19021, 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 taxpayers, the taxpayers in turned 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 the 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 of 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 S Corp (the “Additional Loans”), which the IRS conceded gave rise to basis in indebtedness within the meaning of § 1366(d)(1)(B).

The taxpayers increased their basis in S Corp under § 1366(d)(1)(B) by 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 § 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 and Oren, 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 § 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 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 § 1366(d)(1)(B), it concluded that any basis increase resulting from such 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. 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 the loan restructuring was to obtain an increase in the taxpayer’s basis in an S corporation, and in turn, enabled the taxpayer to deduct losses incurred by the S corporation during the tax year. In general, the IRS and the courts have refused to allow a shareholder to increase his 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) which are then loaned or contributed by the shareholder to the S corporation. With the issuance of TAM 200619021, the IRS has now signaled its intention to apply 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.

[12] Summary of Recent Cases and Rulings

While several Tax Court decisions, Hitchens, Bhatia, Cubnen, Yates and Ruckriegel, 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 restructurings of loans between related entities, Oren, Thomas, Kaplan, Miller (even though decided in favor of the taxpayer) and TAM 200619021 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 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.

§ 15.06 LOAN RESTRUCTURINGS SHOULD RESULT IN BASIS INCREASE REGARDLESS OF WHETHER OBLIGEE ON SHAREHOLDER’S NOTE IS UNRELATED THIRD-PARTY LENDER OR RELATED CORPORATION

[1] No Statutory or Economic Basis for Distinctions

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 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. 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 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 Revenue Ruling 75-144 or Gilday, and as discussed above, there is 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 IRS is simply assuming that if the loan is between related parties it will never be repaid and therefore, that no real indebtedness exists. The IRS’s

63 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.

64 If the IRS and the courts assume that a taxpayer will never make demand upon himself 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.

65 See Ruckriegel, § 15.05[9] supra.

66 In Prashker v. Commissioner, 59 T.C. 172 (1972), the IRS argued, and the Tax Court found, that the taxpayer-shareholder could not apply the attribution rules of § 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 § 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 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 shareholders to increase their basis in the S corporation. See Millar v. Commissioner, T.C. Memo 1975-113, rev’d on another issue, 540 F.2d 184 (3rd Cir. 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.

concern that funds borrowed by a shareholder from his 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 his 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 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.” The IRS is implicitly applying an attribution rule in the context of § 1366(d)(1)(B), so that funds which 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 § 1366(d) or in any other section of the Code, the IRS simply has no authority to apply such a rule. The economic outlay rule should have no application outside of the loan guarantee area.

Undoubtedly, the IRS would treat a loan to a shareholder from his controlled or
wholly-owned S corporation as "indebtedness" for purposes of the imputed interest rules under § 7872. Thus, it is inequitable for the IRS to treat such amounts as "indebtedness" for purposes of § 7872, while at the same time not treating those same amounts as "indebtedness" for purposes of § 1366(d)(1)(B) when the shareholder loans such funds to his 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 § 465.67

Quite simply, provided that there is a bona fide indebtedness between a shareholder 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 § 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 (as in Wilson), and in circumstances in which actual monies are transferred by the shareholder to the S corporation (as in TAM 9403003).

**[2] Basis Increase is Particularly Appropriate Where Loan Restructuring is Accomplished by Means of Distribution of Promissory Note 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 § 1368, the distributed loan should clearly constitute an indebtedness of S-1 to the shareholder under § 1366(d)(1)(B), since the shareholder will have acquired a tax cost basis in such loan.

Under the general rules of § 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

67 For purposes of the at-risk limitation rules under § 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. Treas. 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 creditor corporation, as in the situation presented in TAM 9403003, the shareholder should be treated as if it were distributed to the shareholder as a dividend and then reconstituted by him to his S corporation.

68 In the event that the S corporation has subchapter C E&P, § 1366(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 1366(e).

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

70 In Miles Prod. Co. v. Commissioner, T.C. Memo 1969-274, aff’d on other issues, 457 F.2d 1150 (5th Cir. 1972), the Tax Court held that a shareholder should 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 reconstituted by him to his S corporation.

71 See J. Eustice & J. Kantz, note 40 supra at ¶ 9.05[2][m], where the authors contend that the actual economic outlay requirement should not be applied to deny the pass-through of losses to a shareholder where that shareholder actually holds the debt of the S corporation and has a basis in the debt under general tax rules (as the shareholder had in Wilson).
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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.72

§ 15.07 WAYS TO RESTRUCTURE LOANS CONSISTENT WITH COURTS' AND IRS'S POSITION

A shareholder who desires to restructure a non-qualifying loan, but who does not want to challenge the IRS's position on loan restructurings, has several options in restructuring the loan depending upon whether the original loan was made by an unrelated third-party lender or by a related corporation.

[1] Original Loan Made by Unrelated Third-Party Lender

If the original loan was made by an unrelated third-party lender to the S corporation, the shareholder could rely on Revenue Ruling 75-144 and Gilday, and merely substitute his personal promissory note for the corporation's promissory note which would be canceled by the third-party lender, with the S corporation issuing a new note payable to the shareholder. A more prudent course of action would be to follow the approach set forth in Letter Ruling 8747013. Under this approach, the shareholder would first borrow the funds from the unrelated third-party lender, loan such funds to the S corporation, which would in turn use the funds to satisfy its original indebtedness to the third-party lender. In this manner, the shareholder would clearly meet the actual economic outlay requirement since the shareholder would be transferring actual funds to the S corporation, and, as such, would be entitled to increase his basis in the S corporation by the amount of funds he transferred to the S corporation.

[2] Loan Originally Made by Related Corporation

If the loan was originally made by a corporation controlled by the shareholder to the S corporation, however, a more difficult problem is encountered by the shareholder. An alternative that should produce a basis increase would be for the shareholder to borrow funds from an unrelated third-party lender (which could be guaranteed by the controlled corporation originally making the loan), have the shareholder lend such funds to the S corporation, which would in turn repay the original indebtedness to the shareholder's other controlled corporation. Under these circumstances, the shareholder should be treated as making an actual economic outlay sufficient to justify a basis increase, even in the IRS's overly restrictive view. Absent the interjection of an unrelated third-party lender, however, it does not appear that a shareholder can, in the IRS's view, successfully restructure a loan originally made by a related corporation in a manner that will permit the shareholder to increase his basis in the S corporation.

§ 15.08 CONCLUSION

TAM 9403003 sets forth the IRS's position, based upon Underwood and its progeny, that amounts loaned by a shareholder to his wholly-owned S corporation will not constitute indebtedness of the S corporation to the shareholder within the meaning of § 1366(d)(1)(B), where the loan was originally structured as a loan from another corporation controlled by the shareholder to the S corporation. The position taken by the IRS in TAM 9403003 is not justified by the Code or economic reality, and is even more egregious in situations where the original loan is distributed as a dividend by the controlled corporation to the shareholder, or where the shareholder transfers actual funds to the S corporation in connection with loan restructuring. Although several cases decided since TAM 9403003 provided taxpayers with hope that the courts were changing their position, other cases as well as rulings have indicated that the IRS and the courts are not changing their positions, and may in fact be taking an even more aggressive position with respect to back-to-back loans.

72 See J. Eustice & J. Kuntz, note 40 supra at ¶ 9.05[2][c]. It has been suggested that the IRS's position in TAM 9403003 may have been motivated, at least in part, by the fact that the loan restructuring occurred at year end (December 20, 1994). The timing of the loan restructuring should not, however, be determinative if the loan is restructured in a proper manner as it was in TAM 9403003 so that the shareholders are actually transferring funds to the S corporation prior to year end, and the loan otherwise represents a bona fide indebtedness of the S corporation to the shareholder rather than a sham transaction.