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July 26, 2010

Hon. Douglas Shulman  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments on Qualification of Debt as Indebtedness of the S Corporation to the Shareholder

Dear Commissioner Shulman:

Enclosed are comments on qualification of debt as indebtedness of the S corporations to the shareholder. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stuart M. Lewis  
Chair, Section of Taxation

Enclosure

cc: Michael Mundaca, Assistant Secretary (Tax Policy), Department of the Treasury  
William Wilkins, Chief Counsel, Internal Revenue Service  
Jeffrey Van Hove, Acting Tax Legislative Counsel, Department of the Treasury  
Curt G. Wilson, Associate Chief Counsel, Office of Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service

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**ABA SECTION OF TAXATION  
COMMENTS ON QUALIFICATION OF DEBT AS  
“INDEBTEDNESS OF THE S CORPORATION TO THE  
SHAREHOLDER”**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Stephen R. Looney of the Committee on S Corporations of the Section of Taxation. Substantive contributions were made by Steven B. Gorin, Craig H. Houghton, William D. Klein, Ronald A. Levitt, and Thomas J. Nichols. The Comments were reviewed by Thomas J. Nichols, Committee Chair. The Comments were further reviewed by C. Wells Hall III of the Section’s Committee on Government Submissions and Leslie E. Grodd, Council Director for the Committee on S Corporations.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date:                                     July 26, 2010

## EXECUTIVE SUMMARY

These Comments discuss whether “back-to-back loans” made to an S corporation should qualify as “indebtedness of the S corporation to the shareholder” within the meaning of section 1366(d)(1)(B).<sup>1</sup> As used herein, a “back-to-back” loan is a loan made by a shareholder to an S corporation from funds borrowed by the shareholder from another party, who may or may not be related to the shareholder. We recommend that the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) adopt regulations to provide that bona fide back-to-back loans create “indebtedness of the S corporation to the shareholder” within the meaning of section 1366(d)(1)(B), provided the initial loan transaction creates genuine indebtedness enforceable against the shareholder. We believe this should be so regardless of whether the party making that loan is related or unrelated to the shareholder.

Shareholders of an S corporation and partners in a partnership currently are treated differently for purposes of determining basis when loans are made to the corporation or partnership, respectively. A direct loan by a third party to a partnership, whether or not guaranteed by the partners, generates basis at the partner level. A loan made to an S corporation must, however, be made by the shareholder to be considered in determining the shareholder’s basis under the S corporation loss limitation rules.<sup>2</sup> Therefore, some S corporation shareholders have provided financing for the operation of S corporations through the use of back-to-back loans to increase their S corporation bases to facilitate the use of pass through losses for tax purposes.

A bona fide back-to-back loan in the S corporation context creates significant rights on the part of the creditors of the entity loaning funds to the S corporation shareholder. The lending entity becomes a creditor of the shareholder, and the lending entity (including its creditors in the event of bankruptcy) has legal rights to enforce collection of the lending entity’s loan receivable from the shareholder if necessary. Neither the statutory language nor the economics of the transaction support a conclusion that a back-to-back loan should be disregarded for purposes of determining an S corporation shareholder’s basis in the S corporation.

Thus, we recommend that Treasury and the Service adopt regulations that provide for basis increases under section 1366(d)(1)(B) for bona fide loans from shareholders to S corporations, regardless of the source of the shareholder funds used to make the loan, provided that, if the shareholder borrowed the funds, there is an enforceable debt between the shareholder and the lender of the funds. We also recommend that the Regulations focus on those factors that would be critical in establishing the legal enforceability of the loans against the shareholder and the S corporation, respectively. We believe such factors include contemporaneous written documentation, clear payment terms and obligations, and disclosure in financial statements. If the initial lender and its creditors have an enforceable obligation from the shareholder to repay

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<sup>1</sup> References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

<sup>2</sup> I.R.C. § 1366(d)(1).

the loan, we believe there is no statutory or policy reason not to respect the loans for purposes of section 1366(d)(1)(B).

## DISCUSSION

### I. BACKGROUND

These Comments discuss whether back-to-back loans should qualify as “indebtedness of the S corporation to the shareholder” within the meaning of section 1366(d)(1)(B), which would increase basis to support the shareholder’s deduction of losses passed through to the shareholder under Subchapter S.

A back-to-back loan refers to an arrangement in which an S corporation shareholder borrows funds from an unrelated or related third party, and then lends such funds to the S corporation. A loan may be structured as a back-to-back loan at the outset to enable the shareholder to obtain a basis increase immediately upon infusion of the funds into the corporation or the back-to-back loan may arise when a loan that was originally structured as a direct loan from the third party to the S corporation is restructured as a back-to-back loan, to provide a basis increase for the shareholder or for some other reason.

### II. BASIS LIMITATION ON PASS THROUGH OF LOSSES AND DEDUCTIONS

Under section 1363(a), an S corporation generally is treated as a pass-through entity, and not a taxable entity, for federal income tax purposes. As such, the S corporation’s shareholders generally are subject to only one level of tax on the corporation’s 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 taken into account directly by its shareholders in proportion to their ownership interests in the corporation. In this respect, S corporations and their shareholders are treated similarly to partnerships and their partners.<sup>3</sup>

An S corporation shareholder may deduct the allocable portion of the S corporation’s losses under section 1366(a) only if the shareholder has sufficient basis in the S corporation’s stock or debt under the basis limitation rules of section 1366(d). In this respect, S corporations are similar to partnerships.<sup>4</sup> Section 1366(d)(1) provides, however, that the total amount of losses and deductions taken into account by an S corporation shareholder for any taxable year may not exceed the sum of:

1. The adjusted basis of the shareholder’s stock in the S corporation<sup>5</sup> and
2. The shareholder’s adjusted basis in any indebtedness of the S corporation to the shareholder.<sup>6</sup>

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<sup>3</sup> See I.R.C. § 702.

<sup>4</sup> See I.R.C. § 704(d).

<sup>5</sup> I.R.C. § 1366(d)(1)(A).

<sup>6</sup> I.R.C. § 1366(d)(1)(B).

Under section 1366(d)(1), S corporation shareholders are treated differently than partners of partnerships. Under the partnership rules, “[a]ny increase in a partner’s share of the liabilities of a partnership . . . shall be considered as a contribution of money by such partner to the partnership,” which creates additional basis available to absorb losses for the partner.<sup>7</sup> Thus, even a third-party loan to the partnership (whether or not guaranteed by the partners) may generate basis at the partner level, whereas for S corporations the loan must be made by the shareholder so that it becomes “indebtedness of the S corporation to the shareholder” for there to be a basis increase under the S corporation loss basis limitation rules.<sup>8</sup>

Section 1366(d)(1)(B) does not specifically define what constitutes “indebtedness of the S corporation to the shareholder.” The Senate Finance Committee Report accompanying prior section 1374(c)(2), the predecessor to current section 1366(d), indicates that the purpose of the section is to limit the amount of an S corporation’s loss that may be deducted by a shareholder to the “adjusted basis of the shareholder’s *investment* in the corporation.”<sup>9</sup>

Cases and rulings interpreting section 1366(d)(1)(B) generally have held that indebtedness of the S corporation must be owed to the shareholder, and not to a related entity, for the indebtedness to increase the basis available to absorb losses from the S corporation.<sup>10</sup> Thus, shareholders have been denied an increase in basis with respect to loans made to their S corporations by other corporations,<sup>11</sup> partnerships,<sup>12</sup> trusts<sup>13</sup> and estates<sup>14</sup> in which the

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<sup>7</sup> See I.R.C. §§ 752(a), 722.

<sup>8</sup> Section 1366(d)(2) provides for a carryover of any losses or deductions passing through to an S corporation shareholder that are disallowed because of the basis limitation rules prescribed under section 1366(d)(1). The carryforward of losses under section 1366(d)(2) generally ceases when the shareholder’s interest in the S Corporation terminates, the shareholder dies, or the corporation ceases to be an S corporation. Reg. § 1.1366(a)(5), (b).

<sup>9</sup> S. Rep. No. 85-1983, at 220 (1958) (emphasis added). In *Perry v. Commissioner*, 54 T.C. 1293 (1970), *aff’d* 1971 WL 2651 (8<sup>th</sup> Cir. 1971), the Tax Court concluded that the committee report “reveals an intent on the part of the committee, to limit the applicability of section 1374(c)(2)(B) to the actual economic outlay of the shareholder in question.” The facts of *Perry*, however, involved a shareholder “borrowing” money from an S corporation and then “lending” the same funds back to the same S corporation, in effect creating corporate indebtedness to the shareholder without any additional cash investment in the S corporation. Citing *Knetsch v. United States*, 364 U. S. 361 (1960), the Tax Court stated that “(v)iewed from our vantage point, the facts of this case yield an aroma of alchemist’s brew.” In these comments, we are not addressing the result in the *Perry* decision or in similar decisions in which mirror loans between the shareholder and the same S corporation are used to attempt to create corporate indebtedness to the shareholder.

<sup>10</sup> *But see Miles Prod. Co. v. Commissioner*, 28 T.C.M. (CCH) 1387, 1969 T.C.M. (RIA) ¶ 29876, *aff’d on other issues*, 457 F.2d 1150 (5<sup>th</sup> Cir. 1972) (shareholder allowed to increase his basis in an S corporation with respect to a loan made to the S corporation from a related corporation because 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).

<sup>11</sup> *Burnstein v. Commissioner*, 47 T.C.M. (CCH) 1100, 1984 T.C.M. (RIA) ¶ 40997 (shareholders not allowed to increase basis when their S corporation borrowed money from another S corporation in which the shareholders also owned an interest).

<sup>12</sup> *Frankel v. Commissioner*, 61 T.C. 343 (1973), *aff’d without published opinion*, 506 F.2d 1051 (3<sup>rd</sup> Cir. 1974) (shareholders not allowed to increase basis when their S corporation borrowed money from a partnership in which the shareholders were partners); Rev. Rul. 69-125, 1969-1 C.B. 207 (same).

shareholders held interests. In *Bader v. Commissioner*,<sup>15</sup> the Service 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, because the loan had been restructured so that it was a loan from the bank to the S corporation (rather than to the shareholder).<sup>16</sup> Thus, S corporation shareholders are not able to deduct losses based on loans to S corporations made by third parties, whereas partners in partnerships are able to do just that. Respecting back-to-back loans for S corporation basis purposes would allow S corporation shareholders to make loans consistent with the statutory requirements to accomplish a result similar to what has long been permitted in the partnership context.

In addition to the basis limitation rules of section 1366(d), S corporation shareholders seeking to deduct their pro rata shares of losses are faced with two other substantial loss limitation rules. First, they must have a sufficient amount “at risk” to deduct their share of the losses under the at-risk limitation rules of section 465.<sup>17</sup> Second, such loss deductions also are subject to the passive activity loss limitations of section 469, which limit the deductibility of losses when taxpayers do not participate in the activities giving rise to the losses. These comments relate solely to the application of the basis limitation rules, and are not intended to affect the application of the at-risk and passive activity rules to prevent loss deductions.

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<sup>13</sup> *Robertson v. United States*, 73-2 USTC (CCH) ¶ 9645 (D. Nev. 1973) (shareholders not allowed to increase basis when their S corporation borrowed money from a trust in which the shareholders were beneficiaries).

<sup>14</sup> *Prashker v. Commissioner*, 59 T.C. 172 (1972) (shareholder not allowed to increase basis when S corporation borrowed money from an estate in which the shareholder was the sole beneficiary).

<sup>15</sup> 52 T.C.M. (CCH) 1398, 1987 T.C.M. (RIA) ¶ 43637.

<sup>16</sup> Although the courts and the Service generally have required that indebtedness of the S corporation be a direct obligation to the shareholder and not to another entity in which the shareholder owns an interest for a shareholder to increase basis under section 1366(d)(1)(B), several recent decisions have applied the so-called “incorporated pocketbook” theory to find that indirect loans increased basis. See *Culnen v. Commissioner*, 79 T.C.M. (CCH) 1933, 2000 T.C.M. (RIA) ¶ 2000-139; *Yates v. Commissioner*, 82 T.C.M. (CCH) 805, 2001 T.C.M. (RIA) 2001-280. Under this theory, if the shareholder has habitually used the corporation to make personal expenditures on the shareholder’s behalf (i.e., as an “incorporated pocketbook”), the Tax Court has treated the related corporation as having made the loan on behalf of, or as agent for, the shareholder and specifically stated that the taxpayer has simply skipped the steps of having the corporation first lend the funds to the shareholder and then having the shareholder lend the funds to the S corporation. In essence, the cases have allowed basis increases for taxpayers who ignored corporate formalities and simply operated their related entities in a “sloppy” fashion, while denying basis to taxpayers who have properly structured and carefully documented their back-to-back loan restructurings. See, e.g., *Bergman v. United States*, 74 F. 3d 928 (8<sup>th</sup> Cir. 1999); *Kerzner v. Commissioner*, 97 T.C.M. (CCH) 1375, 2006 T.C.M. (RIA) ¶ 2009-76. We believe that rewarding sloppy taxpayers and penalizing careful taxpayers is not good tax policy.

<sup>17</sup> See generally August & Looney, *S Shareholders Must Still Be Wary Of At-Risk Rules: Part II*, 3 J. S Corp. Tax’n 179 (1992); August & Looney, *S Shareholders Must Still Be Wary Of At-Risk Rules: Part I*, 3 J. S Corp. Tax’n 99 (1991); August, *Basis Traps Under Subchapter S: Competing In The Basis Triathlon*, 48 N.Y.U. Inst. Fed. Tax’n ch. 7 (1990); Wiesner, *S Corporation Basis, At-Risk And Passive Loss Limitations After Tax Reform*, 46 N.Y.U. Inst. Fed. Tax’n ch. 12 (1988); Bravenec, *S Corporations and Shareholders Under the At-Risk Rules of Section 465 - Revisited*, 36 Tax Law. 765 (1983); Bravenec, *Subchapter S Corporations and Shareholders Under the At-Risk Rules of Section 465*, 36 Tax Law. 93 (1982).

**III. BACK-TO-BACK LOANS ARE NOT INHERENTLY ABUSIVE TRANSACTIONS REGARDLESS OF WHETHER FUNDS ARE PROVIDED BY AN UNRELATED THIRD PARTY OR A RELATED PARTY AND SHOULD BE RESPECTED IF THE ORIGINAL LOAN IS ENFORCEABLE AGAINST THE INTERVENING SHAREHOLDER**

We believe the absence of inherent abuse potential in back-to-back loans may be demonstrated by a simple example. Suppose individual A owns 90% of the stock of two S corporations, X and Y. Suppose further that corporation Y needs \$1 million of additional cash to buy a machine and A loans the money to corporation Y from A's personal funds. A would be entitled to basis for the \$1 million loaned to Y. In this situation A is not "poorer" in any sense, technical or otherwise. A has \$1 million less in the bank, but now holds a \$1 million note payable by corporation Y.

Suppose, however, that instead A causes corporation X to loan \$1 million to corporation Y. The \$1 million loan generally would not produce additional basis that A could use to support the deduction of losses passed through from corporation Y.<sup>18</sup> Almost the exact opposite results would be obtained if X and Y were limited liability companies treated as partnerships under the Code. The additional outside loan would create additional basis at the partner level, which, in turn, would be fully available to the partners to support the deduction of losses under section 704(d), subject, of course, to the at-risk and passive activity rules that are applicable to both partners and S corporation shareholders. None of the shareholders or the partners in any of these scenarios is "poorer." One of the related entities has \$1 million less cash, but now has a \$1 million note receivable. The other entity received cash, but owes it back to the first entity, with interest.

Finally, suppose that A borrows \$1 million from corporation X, which A loans to corporation Y. Once again, neither A, nor for that matter either corporation X or corporation Y, is "poorer." They have simply reconfigured their respective assets and liabilities. Independent of the tax consequences, however, interposing A between corporation X and corporation Y, as a borrower from corporation X and a lender to corporation Y, has substantively changed A's financial and legal rights. A now owes \$1 million to corporation X. This debt exists regardless of whether corporation Y ever repays its note to A. We do not believe A's borrowing from corporation X and lending to corporation Y should be treated differently from A's lending \$1 million of personal funds to corporation Y.

Moreover, we believe economic uncertainty also should be taken into account. Regardless of how favorable things may look when the loans are made, either or both of corporation X and corporation Y ultimately may become bankrupt. Should both X and Y become bankrupt, interposing A between the two corporations will have a significant effect. A likely would be required to pay to corporation X's creditors \$1 million of A's personal funds, plus interest, while receiving little or nothing in payment of A's note receivable from

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<sup>18</sup> *But see Miles Prod. Co. v. Commissioner*, 28 T.C.M. (CCH) 1387, 1969 T.C.M. (RIA) ¶ 29876, *aff'd on other issues*, 457 F.2d 1150 (5th Cir. 1972) (shareholder allowed to increase his basis in an S corporation with respect to a loan made to the S corporation from a related corporation because 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).

corporation Y. In fact, there is a decent chance that A's claim as a shareholder and creditor of corporation Y would be subordinated to the claims of other creditors of corporation Y in any bankruptcy by corporation Y.<sup>19</sup> Moreover, even if corporation Y repaid the note to A before the bankruptcy, the payment might be voidable as a preference. A is likely to be considered an "insider" as to corporation Y; if so, A would have to return any such payments received within the one-year period preceding bankruptcy.<sup>20</sup>

In summary, if there is a bona fide indebtedness between a shareholder and an entity controlled by such shareholder and the shareholder loans those funds to an S corporation, the loan to the S corporation is indebtedness of the S corporation to such shareholder, and we believe should be so treated for purposes of section 1366(d)(1)(B). We have reviewed and generally concur with comments on back-to-back loans submitted by the American Institute of Certified Public Accountants ("AICPA") to Treasury and the Service on May 29, 2009.<sup>21</sup> In particular, we believe that the requirements that must be met to fall within the AICPA's proposed safe harbor are relevant factors in determining whether a bona fide indebtedness exists. We believe, however, that a safe harbor is unnecessary, because the statute is unambiguous. We recommend that the regulations provide that back-to-back loans increase basis so long as the indebtedness of the shareholder to the party that loaned the funds to the shareholder is enforceable.<sup>22</sup>

**IV. THE "ECONOMIC OUTLAY" AND "POORER IN A MATERIAL SENSE" LANGUAGE IN SOME CASES DOES NOT PROVIDE A WORKABLE BASIS FOR DETERMINING WHETHER DEBT CONSTITUTES "INDEBTEDNESS OF THE S CORPORATION TO THE SHAREHOLDER" UNDER SECTION 1366(d)(1)(B).**

Some cases appear to have concluded that the shareholder must have made an "economic outlay" and must be "poorer in a material sense" for any shareholder debt funded with borrowed funds to constitute "indebtedness of the S corporation to the shareholder" under section 1366(d)(1)(B).<sup>23</sup> As discussed above, however, a shareholder in a bona fide back-to-back loan transaction is not "poorer." In addition, some cases seem to suggest that back-to-back loans are *per se* abusive – especially if the principal source of the funds is the shareholder's related entity.<sup>24</sup> We believe that a more reasoned conclusion is that, because a number of the cases

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<sup>19</sup> See 11 U.S.C. § 510(c); *Pepper v. Litton*, 308 U.S. 295 (1939); *In re Lemco Gypsum, Inc.*, 911 F.2d 1553 (11th Cir. 1990).

<sup>20</sup> See 11 U.S.C. §§ 547(b)(4)(B), 101(3).

<sup>21</sup> American Institute of Certified Public Accountants Tax Executive Committee, Pre-Release Comments on Guidance under Section 1367 Regarding S Corporations and Back-to-Back Loans (May 29, 2009), available at <http://www.aicpa.org/InterestAreas/Tax/Resources/SCorporations/Pages/Pre%20Release%20Comments%20on%20Guidance%20under%20Section%201367%20Regarding%20S%20Corporations%20and%20Back%20To%20Back%20Loans.aspx> (last visited July 21, 2010).

<sup>22</sup> The determination as to whether the indebtedness is enforceable against the shareholder should be made based upon applicable state law.

<sup>23</sup> See, e.g., *Oren v. Commissioner*, 357 F. 3d 854 (8<sup>th</sup> Cir. 2004); *Bergman v. United States*, 174 F. 3d 928 (8<sup>th</sup> Cir. 1999).

<sup>24</sup> See, e.g., *Oren v. Commissioner*, note 23, *supra*; *Kaplan v. Commissioner*, 90 T.C.M. (CCH) 296, 2005 (RIA) ¶ 2005-218.

decided against taxpayer-shareholders have involved poorly documented (or undocumented) loans, backdating of documents and after-the-fact journal entries to support back-to-back loans, such factors should be considered in determining whether or not bona fide enforceable indebtedness of the S corporation shareholder exists on the relevant date. In situations in which no bona fide indebtedness of the S corporation shareholder exists on the relevant date, we agree with the courts and the Service that no basis increase is warranted.

We are not, however, aware of anything inherently abusive about S corporation shareholders borrowing funds from third parties, whether related or unrelated, and then lending such funds to their S corporations to obtain basis increases for their stock in such corporations. In fact, the Service and the courts have allowed basis increases in connection with back-to-back loans, even with respect to loan restructurings, when an unrelated third party lender made the original loan to the S corporation.<sup>25</sup> Additionally, in *Miller v. Commissioner*,<sup>26</sup> and *Rose v. Commissioner*,<sup>27</sup> the courts granted basis increases when the funds for the back-to-back loans were provided by a related party.

We believe the “economic outlay” or “poorer in a material sense” test applied in some, but not all, of the cases would be impractical to apply across the board in all section 1366(d)(1)(B) cases. Moreover, as explained in more detail below, we believe this test lacks a statutory or economic foundation.

#### **A. No statutory basis for “Economic Outlay”/“Poorer in Material Sense” Test**

The Tax Court, in *Ruckriegel v. Commissioner*,<sup>28</sup> concluded:

we find no categorical rule, under section 1366(d)(1)(B), the regulations thereunder, see Reg. § 1.1366-2(a), Income Tax Regs., the applicable case law, or indeed, as a matter of plain common sense, requiring a common shareholder to fund the S corporation’s losses with funds from his mattress or with funds borrowed by him from a bank or other unrelated party, rather than with funds obtained from another controlled entity, in order to obtain a basis in the unprofitable S corporation to the extent of the funding (emphasis added).

Consequently, that court rejected the Service’s argument that the “economic outlay” requirement is met only if a taxpayer uses either personal funds or funds borrowed from an unrelated party. Instead, citing *Yates v. Commissioner*,<sup>29</sup> the court stated “the fact that funds loaned to an S corporation originate with another entity owned or controlled by the shareholder

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<sup>25</sup> See Rev. Rul. 75-144, 1975-1 C.B. 277; PLR 8747013 (Aug. 20, 1987); PLR 9811016 (Dec. 3, 1997); *Gilday v. Commissioner*, 43 T.C.M. (CCH) 1295, 1982 T.C.M. (RIA) ¶ 38994; *Gurda v. Commissioner*, 54 T.C.M. (CCH) 104, 1987 T.C.M. (RIA) ¶ 44107.

<sup>26</sup> 91 T.C.M. (CCH) 1267, 2006 T.C.M. (RIA) 2006-125, *rev’d on another issue*, 540 F.2d 184 (3<sup>rd</sup> Cir. 1976).

<sup>27</sup> 2008-1 USTC ¶50,318, 311 F. App’x 196 (11th Cir. 2008).

<sup>28</sup> 91 T.C.M. (CCH) 1035, 2006 T.C.M. (RIA) ¶ 2006-78.

<sup>29</sup> 82 T.C.M. (CCH) 805, 2001 T.C.M. (RIA) 2001-280.

of the S corporation does not preclude a finding that the loan to the S corporation constitutes an ‘actual economic outlay’ by the shareholder.”<sup>30</sup>

We believe the fact that the funds used by the shareholder originated from a related entity (rather than from an unrelated third party lender or from the shareholder’s personal bank account) does not make such funds any less of an “investment in the corporation” than would be the case with funds obtained by the shareholder from any other source.<sup>31</sup>

The application of the “economic outlay” rule requiring the shareholder to be “poorer in a material sense” after the transaction, as well as any application of a “source of funds” rule, to determine whether the taxpayer is entitled to an increased basis in the S corporation is without any express statutory or regulatory foundation. In effect, an S corporation shareholder is punished for using cash from a source other than an unrelated third-party lender or “his mattress.”<sup>32</sup> The net effect of applying different standards for related party debt would be to create an attribution rule, whereby funds obtained by a shareholder from a related corporation or other entity and then loaned to an S corporation controlled by that same shareholder are disqualified from being treated as indebtedness of the S corporation to the shareholder under section 1366(d)(1)(B). Neither the statute nor the regulations include any such attribution rule and we do not believe such an attribution rule should be applied.<sup>33</sup>

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<sup>30</sup> See also *Hitchins v. Commissioner*, 103 T.C. 711 (1994) (stating that if a related C corporation had released the S corporation from liability by a novation and a replacement note had been issued by the S corporation to its shareholder who had assumed the S corporation’s indebtedness to the related C corporation, or alternatively, if the shareholder had loaned \$34,000 to his S corporation, followed by the S corporation’s payment of its debt to the related C corporation, and the related C corporation’s loan of such funds to the shareholder (*i.e.*, a circular flow of funds) the shareholder should have been entitled to a basis increase under section 1366(d)(1)(B)); *Bhatia v. Commissioner*, 72 T.C.M. (CCH) 696, 1996 T.C.M. (RIA) ¶ 51565 (stating that a loan from a related corporation in a back-to-back loan restructuring is *not* necessarily fatal if other elements are present which clearly establish the bona fides of the transaction and their economic effect citing (1) *Hitchins*, *supra*, 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 proposition that loan restructurings between related entities, if properly structured and documented, should result in a basis increase for S corporation shareholders).

<sup>31</sup> See note 9, *supra*.

<sup>32</sup> See *Ruckriegel*, 91 T.C.M. (CCH) 1035, 2006 T.C.M. (RIA) ¶ 2006-78.

<sup>33</sup> In *Prashker v. Commissioner*, 59 T.C. 172 (1972), the Service argued, and the Tax Court found, that the taxpayer-shareholder could *not* apply the attribution rules of section 267 to treat a loan to his S corporation from an estate in which the shareholder was the sole beneficiary as a loan from the shareholder, and as such, the loan between the estate and the S corporation did not constitute indebtedness of the S corporation to the shareholder within the meaning of section 1366(d)(1)(B). We believe that denying taxpayers the use of an attribution rule in the taxpayers’ favor, while at the same time implicitly applying an attribution rule to treat funds received from a related party differently from other funds for basis purposes, is both inequitable and not authorized by the Code. Moreover, some decisions hold 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 for loss purposes. See, e.g. *Miller v. Commissioner*, 91 T.C.M. (CCH) 1267, 2006 T.C.M. (RIA) 2006-125, *rev’d on another issue*, 540 F.2d 184 (3<sup>rd</sup> Cir. 1976); *Rose v. Commissioner*, 2008-1 USTC ¶50,318, 311 F. App’x 196 (11th Cir. 2008).

## **B. No economic basis for “Economic Outlay” or “Poorer in a Material Sense” test**

In addition to the lack of statutory authority discussed in the preceding section, we do not believe that there is any economic basis for requiring an S corporation shareholder to have made an economic outlay such that the shareholder is “poorer in a material sense” to obtain a basis increase under section 1361(b)(1)(D). As explained above in Section III, in an economic sense, a shareholder is *never* poorer after the shareholder makes a loan (regardless of how the shareholder obtained the funds to make the loan). Rather, the shareholder has merely shifted assets from cash to notes receivable, while the shareholder’s net worth has remained the same.<sup>34</sup>

The argument that there is an economic basis for the proposition that funds borrowed from a related party should not be counted for basis purposes would appear to be based on the implicit assumption that if the initial loan is between related parties, it will never be repaid and, therefore, is not real indebtedness.<sup>35</sup> We believe that any such concern that funds borrowed by a shareholder from a controlled or wholly owned corporation will not be repaid is misplaced. If the source of the loan to the shareholder is a corporation wholly owned by the shareholder, it is no different from the case in which the shareholder takes the funds from a bank account wholly owned by the shareholder – the shareholder bears the entire economic risk of loss if the second loan is not repaid. If the source of the initial loan to a shareholder is 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 initial loan on behalf of the corporation in the event the shareholder does not repay the loan to the lending corporation. Even in the context of a wholly owned corporation, third-party creditors likewise would have a cause of action to compel repayment of the loan if that corporation fails to satisfy their claims; if it is clear that the corporation will satisfy all such creditor claims, then the funds procured by such shareholder from the corporation are clearly available to such shareholder in any event, and should be treated no less favorably than funds drawn from personal bank accounts. In any event, because of economic uncertainty, the interposition of an S corporation shareholder between the lending entity and the S corporation debtor entity has economic significance and creates genuine liability exposure, especially in the event of the bankruptcy of one or both of the entities.

Finally, from an economic standpoint, in situations in which the funds are obtained by the S corporation shareholder from a related corporation or partnership, it is likely that such funds

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<sup>34</sup> Clearly, a current economic outlay leaving the taxpayer “poorer in a material sense” was *not* required in either Rev. Rul. 75-144 or *Gilday* (in which the original loan was made by an unrelated third party lender), and we do not believe there is any 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.

<sup>35</sup> If the Service and the courts assume that a related entity will never make a demand 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 and numerous cases. Regardless of whether a loan is between related parties or unrelated parties, we believe funds procured by a shareholder through a debt which is enforceable by the lender (or its creditors in the event of bankruptcy) should count as part of such shareholder’s basis if loaned to such shareholder’s corporation. It should be noted that such related party debt can and does have both positive and negative consequences for other purposes under the Code. *See, e.g.*, I.R.C. §§ 7872 (deemed gifts); 108 (cancellation of indebtedness).

already will have been subject to taxation (either at the entity level in the case of a C corporation or at the shareholder or partner level in the case of an S corporation or partnership). In these situations, the C corporation or the S corporation shareholder/partner has a tax basis in such funds, and we believe that there is no economic basis to support a denial of a basis increase when such funds are then loaned by the shareholder to the borrowing S corporation.

## **V. DOUBLE-COUNTING CONCERN**

We understand that the Service has some concern that recognizing basis in related party loan situations under section 1366(d)(1)(B) might have the potential for double-counting shareholder investment. We are not clear as to exactly how this is thought possible, but we assume that the concern involves a situation in which a shareholder, A for example, lends or contributes cash or property to one entity, say \$1 million to corporation X, then subsequently borrows \$1 million from corporation X and lends the same \$1 million to corporation Y, which is an S corporation.

This does not appear to present a potentially abusive situation for a number of reasons. First, if the \$1 million loaned or contributed to X is still available within X to be loaned back to A, then it has not been used in a manner that has triggered a deduction for any taxpayer (A in the event X is an S corporation, X in the event X is a C corporation). Thus, if the \$1 million is subsequently used by Y for deductible purposes, this would trigger one, and only one, \$1 million deduction.

Second, suppose X is somehow able to spend (and deduct) the \$1 million loaned or contributed by A to it, and still be in a position to loan \$1 million back to A. This means that X either has other cash or other assets convertible into cash or has enough credit with outside parties to generate cash from a source other than the loan proceeds from A (which have been spent). In either case, corporation X has other assets or sufficient credit to generate the cash to lend \$1 million back to A. X could have taken such cash and either repaid A's loan or distributed a dividend to A, or perhaps even avoided the initial loan or contribution from A to begin with (and used the cash so generated directly in its business instead of A's funds). Thus, to the extent there is any deduction to X despite the relending of these funds back to A, that deduction has effectively been created through property or credit that X could have used to raise the cash and generate the deduction in the first place without the loan of any funds from A.

In any event, it appears that any deductions for both X and Y are likely to result only from real economic expenditures by both entities in the same fashion as they are for other business entities.

## **VI. RECOMMENDATION**

We recommend that Treasury and the Service adopt regulations that provide for basis increases under section 1366(d)(1)(B) for bona fide loans made by shareholders to S corporations, regardless of the source of the funds used by the shareholder to make the loan, provided that, if the shareholder borrowed the funds, there is an enforceable debt between the shareholder and the lender of the funds. Adopting a "facts and circumstances" test for back-to-back loans would be helpful if the regulations focus on factors that would be critical in

determining the legal enforceability of the initial loan against the shareholder. Such factors include contemporaneous written documentation, clear payment terms and obligations, and disclosure in financial statements. If the initial lender and its creditors have an enforceable obligation from the shareholder to repay the loan, we believe there is no statutory or policy reason for not respecting that shareholder's subsequent loan of the borrowed funds to an S corporation for tax purposes under section 1366(d)(1)(B).