September 17, 2012

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

Re: Comments on Proposed Amendments to Section 1.1366-2 Regulations

Dear Commissioner Shulman:

Enclosed are comments on proposed amendments to section 1.1366-2 regulations. 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,

Rudolph R. Ramelli
Chair, Section of Taxation

Enclosure

cc: Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury

William J. Wilkins, Chief Counsel, Internal Revenue Service

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ABA SECTION OF TAXATION
COMMENTS ON PROPOSED AMENDMENTS TO
SECTION 1.1366-2 OF THE INCOME TAX REGULATIONS
REGARDING THE BASIS OF INDEBTEDNESS OF
S CORPORATIONS TO THEIR SHAREHOLDERS

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 S Corporations Committee of the ABA Section of Taxation. Substantive contributions were made by Ronald A. Levitt and Laura Howell-Smith. The Comments were reviewed by William D. Klein, Committee Chair. The Comments were further reviewed by Jeffrey H. Paravano of the Section’s Committee on Government Submissions and by W. Curtis Elliott Jr., Council Director for the S Corporations Committee.

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: September 17, 2012
EXECUTIVE SUMMARY

On June 12, 2012, the Service and the Treasury Department issued a Notice of Proposed Rulemaking (REG-134042-07), proposing Regulations under section 1366(d)(1)(B) addressing basis increases with respect to loans made by S corporation shareholders to their S corporations (the “Proposed Regulations”).

The Proposed Regulations provide helpful guidance clarifying when a shareholder is entitled to increase basis for indebtedness of the S corporation to such shareholder. We recommend clarifications and suggest the addition of at least one example. In view of the uncertainty and inconsistent judicial decisions regarding basis increases with respect to loan transactions involving multiple parties, including back-to-back loans, the guidance is a significant improvement over the current state of the law which has applied the “actual economic outlay” test to determine whether a shareholder is entitled to a basis increase under section 1366(d)(1)(B).

Although the Proposed Regulations expressly reject the application of the actual economic outlay test in the preamble, they do not directly reject this test in the body of the Regulations. We recommend that the final Regulations themselves (rather than just the preamble) state that so long as the indebtedness of the S corporation to the shareholder constitutes bona fide indebtedness, the shareholder will increase the shareholder’s basis in indebtedness of the S corporation under section 1366(d)(1)(B) without satisfying the actual economic outlay test articulated in court cases.

The Proposed Regulations set forth an example providing a basis increase under section 1366(d)(1)(B) where one S corporation (S1) assigns its creditor position in a note from another S corporation (S2) to the sole shareholder of the two corporations by making a distribution to the common shareholder of the note. In this example, local law provides that such distribution results in S2’s relief of liability to S1 and S2 becoming directly liable to the common shareholder. We recommend that the Regulations should be clarified to reflect that even if local law does not operate to relieve S2 of its liability to S1, the common shareholder should still increase the shareholder’s basis with respect to S2 under section 1366(d)(1)(B).

Although the Proposed Regulations provide an example of back-to-back loans that will result in a shareholder increasing the shareholder’s basis in the S corporation under section 1366(d)(1)(B), the Proposed Regulations contain no example of loan restructurings achieved through loan repayments involving a circular flow of funds. Our comments provide suggestions for additional guidance in two situations which would result in a basis increase under section 1366(d)(1)(B).

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2 Except to the extent otherwise provided, all “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”), or to the Treasury Regulations promulgated thereunder.
3 The cases have generally required that in order for the shareholder to increase basis under section 1366(d)(1)(B), the shareholder must have made an actual economic outlay in such a manner that the shareholder is “poorer in a material sense” after the transaction than before the transaction began.
Finally, our comments request clarification that the actual economic outlay test should likewise not be applicable in the context of increases in stock basis under section 1366(d)(1)(A).

DETAILED COMMENTS

I. INTRODUCTION

A back-to-back loan in the S corporation context 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 can be structured as a back-to-back loan at the outset to enable the shareholder to obtain a basis increase immediately upon the infusion of funds into the corporation, or a back-to-back loan may arise later when a loan that originally was structured as a direct loan from the third party to the S corporation is restructured as a back-to-back loan in order to provide a basis increase for the shareholder.

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 and/or debt under the basis limitation rules of section 1366(d). Section 1366(d)(1) provides 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: (A) the adjusted basis of the shareholder’s stock in the S corporation, and (B) the shareholder’s adjusted basis in any indebtedness of the S corporation to the shareholder.

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 provision was 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.”

A number of cases and rulings interpreting section 1366(d)(1)(B) had previously established two requirements that generally must be met in order for a loan to constitute “indebtedness of the S corporation to the shareholder” within the meaning of section 1366(d)(1)(B):

1. the indebtedness must run directly from the S corporation to the shareholder; and
2. the shareholder must have made an actual economic outlay in such a manner that the shareholder is poorer in a material sense after the transaction than before the transaction began.

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A. Direct Indebtedness to the Shareholder

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 shareholder’s basis available to absorb losses from the S corporation. Thus, shareholders have been denied an increase in basis with respect to loans made to their S corporations by other corporations, partnerships, trusts and estates in which the shareholders held interests. In Bader, 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 subsequently been restructured so that it was a loan from the bank to the S corporation (rather than to the shareholder).

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 “incorporated pocketbook” theory to find that indirect loans increased basis. 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, such 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 “careless” fashion, while denying basis to taxpayers who have properly structured and carefully documented their back-to-back loan restructurings.

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5 Burnstein v. Comm’r, 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).

6 Frankel v. Comm’r, 61 T.C. 343 (1973), aff’d without published opinion, 506 F.2d 1051 (3rd 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).

7 Robertson v. United States, 32 AFTR2d 73-5556, 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).

8 Prashker v. Comm’r, 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).

9 52 T.C.M. (CCH) 1398, 1987 T.C.M. (RIA) ¶ 43637.


11 See, e.g., Bergman v. United States, 74 F.3d 928 (8th Cir. 1999); Kerzner v. Comm’r, 97 T.C.M. (CCH) 1375, 2006 T.C.M. (RIA) ¶ 2009-76. A practice of rewarding careless taxpayers and penalizing careful taxpayers is not good tax policy. See also Miles Prod. Co. v. Comm’r, 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 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).
B. Actual Economic Outlay

It is the second requirement that has proven most problematic for taxpayers and with respect to which the courts have rendered arguably inconsistent and confusing decisions. Specifically, the Service, and the courts in a number of cases, have found that in order for the S corporation shareholder to receive an increase in basis in connection with a back-to-back loan, the shareholder must have made an actual economic outlay in such a manner that the shareholder is poorer in a material sense after the transaction than before the transaction began. In general, these rulings and cases have tended to allow basis increases only if the funds loaned to the S corporation originally came from an unrelated party as opposed to another entity in which the shareholder has an interest.

The Proposed Regulations provide guidance in three principal areas: (a) basis increases under section 1366(d)(1)(B) by reason of guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan; (b) basis increases in circumstances that involve a loan directly to an S corporation from an entity related to the S corporation shareholder under the incorporated pocketbook theory; and (c) basis increases for traditional back-to-back loans.

II. ANALYSIS AND COMMENTS

We believe that the Proposed Regulations provide helpful and necessary guidance on the issues presented under section 1366(d)(1)(B), which has been fraught with uncertainty for taxpayers and pitfalls for the unwary.

In general, the Proposed Regulations provide that so long as the loan transaction represents bona fide indebtedness of the S corporation to the shareholder, the shareholder should be allowed to increase the shareholder’s basis in the S corporation under section

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12 See the following authorities that denied a basis increase based on the lack of an actual economic outlay in situations involving related parties: Russell v. Comm’r, 97 T.C.M. (CCH) 1122, T.C.M. 2009 (RIA) 2009-029, aff’d, 619 F.3d 908 (8th Cir. 2010); Oren v. Comm’r, 357 F.3d 854 (8th Cir. 2004); Bergman v. United States, 74 F.3d 928 (8th Cir. 1999); Underwood v. Comm’r, 63 T.C. 468 (1975), aff’d, 535 F.2d 309 (5th Cir. 1976); Hitchins v. Comm’r, 103 T.C. 711 (1994); Kerzner v. Comm’r, 97 T.C.M. (CCH) 1375, 2006 T.C.M. (RIA) ¶ 2009-76; Ruckriegel v. Comm’r, 91 T.C.M. (CCH) 1035; Kaplan v. Comm’r, 90 T.C.M. (CCH) 296; Thomas v. Comm’r, 83 T.C.M. (CCH) 1576; Bhatia v. Comm’r, 72 T.C.M. (CCH) 696, 1996 T.C.M. (RIA) ¶ 96429; Wilson v. Comm’r, 62 T.C.M. (CCH) 1122, 1991 T.C.M. (PH) ¶ 91544; Griffith v. Comm’r, 56 T.C.M. (CCH) 1263, T.C.M. (PH) ¶ 89070; Shebester v. Comm’r, 53 T.C.M. (CCH) 824, 1987 T.C.M. (PH) ¶ 87246; and TAM 9403003 (Sept. 29, 1993). But see Rose v. Comm’r, 101 AFTR2d 2008-1888, 2008-1 USTC ¶50,318 (11th Cir. 2008), where the Eleventh Circuit allowed a basis increase in connection with a loan restructuring between related entities; and Maguire v. Comm’r, T.C.M. 2012-160, where the Tax Court allowed a basis increase under section 1366(d)(1)(A) which involved a distribution to the taxpayers from a related corporation and a contribution to the S corporation in which the taxpayers were seeking a basis increase. See the following authorities which permit a basis increase based on the presence of an actual economic outlay in situations involving unrelated parties: Miller v. Comm’r, 91 T.C.M. (CCH) 1267, 2006 T.C.M. (RIA) 2006-125; Gilday v. Comm’r, T.C.M. (CCH) 1982-242, 1982 T.C.M. (PH) ¶ 82242; Rev. Rul. 75-144, 1975-1 C.B. 277; and PLRs 8747013 (Aug. 20, 1987), 9811016, 9811017, and 9811018 (Dec. 3, 1997).

13 Id.
Significantly, the preamble provides that so long as the purported indebtedness of the S corporation to the shareholder is bona fide indebtedness to the shareholder, the S corporation shareholder need not otherwise satisfy the actual economic outlay doctrine for purposes of section 1366(d)(1)(B).

The Proposed Regulations do not attempt to provide a standard for purposes of section 1366 as to what constitutes bona fide indebtedness. Rather, the preamble provides that general federal tax principles determine whether the indebtedness is bona fide. Although some commentators have criticized the Proposed Regulations based on their lack of a definition of what constitutes bona fide indebtedness, the Proposed Regulations’ elimination of the actual economic outlay test is a significant improvement that will reduce the number of disputes between taxpayers and the Service, and we concur that no new standard for determining what constitutes bona fide indebtedness is necessary in the Regulations.

A. Increases in Basis by Reason of Guarantee of Indebtedness

Proposed Regulations section 1.1366-2(a)(2)(ii) specifically provides that a shareholder does not obtain a basis increase merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. The Proposed Regulations provide that when a shareholder makes a payment on bona fide indebtedness for which the shareholder has acted as guarantor or in a similar capacity, based on the facts and circumstances, the shareholder may increase the shareholder’s basis of indebtedness to the extent of such payment. This is consistent with the views of an overwhelming majority of courts that have considered whether shareholders may increase their basis as the result of guarantees of S corporation debt.

We concur with the Proposed Regulations that an S corporation shareholder should not obtain a basis increase merely by reason of guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan, but should obtain a basis increase when the shareholder makes an actual payment under a guarantee.

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14 This rule is consistent with the recommendation of the ABA Section of Taxation Comments on Qualification of Debt as Indebtedness of the S Corporation to the Shareholders (July 26, 2010), available at http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2010/072610comments.authcheckdam.pdf; and AICPA Comments on Back-to-Back Loans (May 29, 2009).


16 See, e.g., Maloof v. Comm’r, T.C.M. 2005-75, 2005 T.C.M. (RIA) ¶ 2005-075, aff’d, 456 F.3d 645 (6th Cir. 2006); Estate of Leavitt v. Comm’r, 875 F.2d 420 (4th Cir. 1989); Frankel v. Comm’r, 61 T.C. 343 (1973), aff’d without published opinion, 506 F.2d 1051 (3rd Cir. 1974); Raynor v. Comm’r, 50 T.C. 762 (1968); Weisberg v. Comm’r, T.C.M. 2010-55; and Wise v. Comm’r, T.C.M. 1997-135, which all denied S corporation shareholders basis increases under section 1366(d)(1)(B) for guarantees of corporate level indebtedness. But see Selfe v. U.S., 778 F.2d 769 (11th Cir. 1985), holding that a shareholder who guaranteed a loan under the circumstances of the case would be permitted to increase the shareholder’s basis in the S corporation where, in substance, that shareholder had borrowed funds and subsequently advanced them to the S corporation (citing Plantation Patterns v. Comm’r, 462 F.2d 712 (5th Cir. 1972)).
B. Increases in Basis by Reason of Direct Loan from Related Entity to the S Corporation: The Incorporated Pocketbook Theory

The preamble to the Proposed Regulations also discusses the incorporated pocketbook theory to claim a basis increase in circumstances that involve a loan directly to the S corporation from an entity related to the S corporation shareholder. In Culnen and Yates, the S corporation shareholder was allowed to increase the shareholder’s basis where the related entity transferred funds directly to the shareholder’s S corporation because the related entity was used as the taxpayer’s incorporated pocketbook. The courts found that in substance the transaction was a loan from the related entity to the shareholder, followed by a loan from the shareholder to the S corporation. Under the Proposed Regulations, a transaction increases basis of indebtedness only where the transaction creates a bona fide creditor-debtor relationship between the shareholder and the borrowing S corporation.

We concur with the result reached in the Proposed Regulations that an incorporated pocketbook type transaction increases basis only where the transaction creates a bona fide creditor-debtor relationship between the shareholder and the borrowing corporation.

C. Increases in Basis for Back-to-Back Loans

As discussed above, the key requirement of the Proposed Regulations in order for a shareholder to obtain an increase in basis under section 1366(d)(1)(B) is that the purported indebtedness of the S corporation to the shareholder be bona fide indebtedness to the shareholder. The Proposed Regulations do not attempt to provide any special standard for purposes of section 1366 as to what constitutes bona fide indebtedness, but rather apply general federal tax principles to determine whether indebtedness is bona fide.

Proposed Regulations section 1.1366-2(a)(2)(iii) provides several examples. In Example 1, A is the sole shareholder of S, an S corporation. A makes a loan to S. The example provides that if the loan constitutes bona fide indebtedness from S to A, A’s loan to S increases A’s basis under section 1366(d)(1)(B). Example 1 goes on to provide that the result is the same if A made the loan to S through an entity that is disregarded as an entity separate from A under Regulations section 301.7701-3.

Example 3 addresses a back-to-back loan transaction. A is the sole shareholder of two S corporations, S1 and S2. S1 loans $200,000 to A, who then loans $200,000 to S2. Example 3 provides that if A’s loan to S2 constitutes a bona fide indebtedness from S2 to A, A’s loan increases the shareholder’s basis under section 1366(d)(1)(B).

In Example 4, A is the sole shareholder of two S corporations, S1 and S2. S1 makes a loan directly to S2, and subsequently S1 assigns its creditor position in the note to A by making a distribution to A of the note. The example provides that under local laws.

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17 See supra Note 10.
18 Id.
law, after S1 distributes the note to A, S2 is relieved of its liability to S1 and is directly liable to A. Example 4 concludes that if the note constitutes bona fide indebtedness from S2 to A, the note increases A’s basis under section 1366(d)(1)(B). Example 4 leaves open the question of whether the result would be the same if S2 is not relieved of its liabilities to S1 under applicable local law. We believe that the Proposed Regulations should be clarified to reflect that even if S2 is not relieved of its liabilities to S1 under applicable local law, A should be able to increase A’s basis under section 1366(d)(1)(B) so long as the indebtedness of S2 to A is bona fide indebtedness.\(^{19}\)

In order to provide further clarity, we suggest that several additional modifications be made to the Proposed Regulations. First, while the preamble expressly rejects the actual economic outlay test in order to obtain a basis increase under section 1366(d)(1)(B), we believe that the Regulations themselves should expressly state that so long as the indebtedness of the S corporation to the shareholder is bona fide indebtedness, the shareholder will be entitled to a basis increase regardless of whether the shareholder has made an actual economic outlay such that the shareholder is poorer in a material sense after the transaction than before the transaction began.

Additionally, we believe it would be helpful to add to the Proposed Regulations examples of loan restructurings achieved through loan repayments that involve a circular flow of funds. Specifically, we suggest that a new Example 5 be added that would involve A, the sole shareholder of two S corporations, S1 and S2. S1 initially makes a loan to S2. Subsequently, S2 repays the loan to S1, which then makes a new loan to A, the sole shareholder, who in turn makes a new loan to S2 (resulting in a circular flow of funds). Alternatively, S1 makes a new loan to A who then makes a new loan to S2, which uses the borrowed funds to repay the original loan made by S1 to S2 (again, involving a circular flow of funds). We believe that such an example should conclude that, so long as the note from S2 to A constitutes bona fide indebtedness, the note increases A’s basis under section 1366(d)(1)(B), just as in the other examples.\(^{20}\)

D. Increases in Stock Basis Under Section 1366(d)(1)(A)

The preamble to the Proposed Regulations states that the Proposed Regulations do not address how to determine the basis of the shareholder’s stock in an S corporation for purposes of section 1366(d)(1)(A). Consequently, the Proposed Regulations leave unchanged the conclusion found in published guidance that a shareholder of an S corporation is not allowed to increase the shareholder’s basis in an S corporation under section 1366(d)(1)(A) upon the contribution of the shareholder’s own unsecured demand promissory note to the corporation. See Rev. Rul. 81-187, 1981-2 C.B. 167.

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\(^{19}\) If the indebtedness of S2 to the shareholder is bona fide, the test prescribed under the Proposed Regulations is satisfied regardless of whether S2 has been relieved of any liability to S1. We do not believe that S2 should be required to obtain a novation of its indebtedness to S1.

\(^{20}\) For examples of where a circular flow of funds resulted in a basis increase where an unrelated third party lender was involved, see PLR 8747013 (Aug. 20, 1987), and Miller v. Comm’r, 91 T.C.M. (CCH) 1267, 2006 T.C.M. (RIA) 2006-125.
While we agree with the Service that a shareholder should not be allowed to increase the shareholder’s stock basis pursuant to section 1366(d)(1)(A) under the specific circumstances set forth in Rev. Rul. 81-187, we do not believe that the Service should apply the actual economic outlay test in cases involving section 1366(d)(1)(A). We see no statutory or economic justification for applying the economic outlay test to determine a shareholder’s basis in stock of the S corporation under section 1366(d)(1)(A), when the economic outlay test is not applicable to determine a shareholder’s basis in indebtedness of the S corporation to such shareholder under section 1366(d)(1)(B).

Therefore, we believe that the Regulations should provide that the actual economic outlay test does not apply in determining basis increases under either section 1366(d)(1)(B) or 1366(d)(1)(A).

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21 We do not believe that the contribution of a shareholder’s own promissory note should increase such shareholder’s stock basis for purposes of section 1366(d)(1)(A). We express no opinion in these comments as to the results reached in Lessinger v. Comm’r, 872 F.2d 512 (2d Cir. 1989), rev’d, 85 T.C. 824 (1985) and Peracchi v. Comm’r, 143 F.3d 487 (9th Cir. 1998), rev’d, 71 T.C.M. (CCH) 2830 (1996), where the courts found that a contribution by a shareholder of his or her own promissory note was considered a contribution of property with a tax basis that prevented the taxpayer from recognizing section 357(c) gain.

22 See Maguire v. Comm’r, T.C.M. 2012-160, where the Tax Court recently applied the actual economic outlay test to increase a shareholder’s stock basis under section 1366(d)(1)(A).