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Purported Debt Instruments Did Not Increase Shareholders' Basis in S Corp

A business loss isn't necessarily a bad thing if you can use the loss to offset other income. And S corporations are efficient vehicles for passing through losses to be used elsewhere, if the shareholder has enough basis in the corporation. In a recent case, two S corporation shareholders reshuffled some debt from other entities they owned to jack up their bases in the corporation to take advantage of its losses on their individual returns. In *Russell v. Commissioner*, however, the Tax Court said that the debt didn't flow from the shareholders to the corporation and couldn't be used to increase their bases in the corporation for purposes of claiming their proportionate shares of its losses.¹

(See **S Corp Basis**, on p. 9)

S Corp Basis, from p. 1

Facts

Before September 1, 1997, Donald Russell and Loren Kopseng were the owners of the Rainbow Gas Company (RGC), a limited partnership; the Rainbow Marketing Energy Corporation (REMC); and the Missouri River Royalty Corporation (MRRC), an S corporation. On September 1, 1997, Donald and Loren transferred their interests in RGC, REMC, and MRRC

to the newly formed United Energy Corporation in exchange for all of its stock in a tax-free, Code Section 351 transaction.

Before the creation of United Energy, Donald and Loren had financed MRRC's operations through a variety of transactions. In August 1996, BNC National Bank lent \$1 million to MRRC. MRRC used the loan proceeds to pay off certain prior loans to buy and rework oil wells. In consideration for the loan, MRRC gave BNC a promissory note for \$1 million.

As of January 3, 1997, the principal balance of the MRRC note was \$927,936. On that date, BNC canceled the MRRC note in consideration for promissory notes from Donald and Loren, each for half of the principal balance. The two notes listed MRRC as the borrower and indicated that they were for the renewal of the MRRC note.

Between January 3 and September 3, 1997, MRRC made eight monthly payments on each note. On September 3, 1997, MRRC paid off the principal balance of \$389,915 on each note. The interest that was accrued and paid on the notes was reported on the 1998 United Energy Form 1120 as an interest expense of MRRC. None of the interest was reported on either Donald's or Loren's 1997 Form 1040.

In April 1996, REMC lent MRRC \$94,000, which MRRC used for working capital. On MRRC's books, the REMC debt was recorded as a liability in a ledger account entitled "Notes Payable Kopseng/Russell Partnership." A note was prepared in connection with the REMC debt, stating that "effective April 1, 1996, Missouri River Royalty Corporation promises to pay Kopseng/Russell Partnership \$94,000 at an interest rate of the applicable federal rate table."

As of September 1, 1997, the principal balance of the REMC debt was \$75,750. On June 30, 1998, an adjusting journal entry to MRRC's books reclassified \$22,042 of the \$75,750 balance of the REMC debt to the notes payable Russell account and \$53,708 of the balance to the notes payable Kopseng account. The adjusting journal entry allocated the balance of the REMC ledger debt between the two accounts in proportion to the interests held by Donald and Loren in REMC at the time the loans were made in April of 1996. As of September 1, 1997, the fair market value of the REMC ledger debt was equal to the REMC ledger debt's principal balance of \$75,750.

During the period between March 7, 1997, and June 16, 1997, MRRC also received a series of short-term loans totaling \$1,830,597. It used the proceeds of the short-term debt for working capital. Between May 13, 1997, and August 27, 1997, MRRC repaid \$629,000 of principal on the short-term debt.

The loans making up the short-term debt were transferred directly from the checking account of the

RGC partnership to the checking account of MRRC. The repayments were transferred directly from the checking account of MRRC to the checking account of the RGC partnership. Before August 31, 1997, the short-term debt was recorded on MRRC's books as a liability in a ledger account entitled "Notes Payable RGC." As of August 31, 1997, an adjusting journal entry to MRRC's books reclassified half the balance of the short-term debt to the notes payable Kopseng account, and half to the notes payable Russell account.

With respect to each of the loans making up the short-term debt, four notes were prepared: (1) one from Donald to the RGC partnership; (2) one from Loren to the RGC partnership; (3) one from MRRC to Donald; and (4) one from MRRC to Loren. The face amount of each note was half of the amount transferred from the RGC partnership to MRRC on the date of the transfer.

Each of the short-term notes bore an "effective" date identical to the date on which the corresponding loan was made to MRRC. Both Donald and Loren signed each of the short-term notes, either in their individual capacities or on behalf of RGC or MRRC, but none of their signatures were dated.

On September 3, 1997, the \$1,138,597 principal balance of the short-term debt was paid by cashier's check from MRRC to RGC. The payment was reflected in MRRC's books by debiting the "Notes Payable Russell account" and the "Notes Payable Kopseng account" each for half the balance of the principal, and debiting the loan interest account with the memo notation "Interest paid to Kopseng and Russell for Note." The payment was reflected in RGC's books by crediting the "Notes Payable Don Russell" and the "Notes Payable Loren Kopseng" ledger accounts for a corresponding amount, and crediting the interest income account with the memo notation "Interest on Note Rec. from MRRC."

The interest on the short-term debt was reported on the 1998 UEC Form 1120 as an interest expense of MRRC and interest income of RGC. None of the interest was reported on Donald's or Loren's 1997 Form 1040.

Taxpayers' Argument

As of the beginning of MRRC's short tax year ending August 31, 1997, Donald's basis in his MRRC stock was \$150,151, and Loren's basis in his MRRC stock was zero. The MRRC 1997 Form 1120S reported an ordinary loss of \$1,117,540. Donald and Loren each reported half the loss on their Forms 1040. They argued that they had bases in the indebtedness of MRRC sufficient to permit them to deduct their pro rata shares of MRRC's ordinary loss for its final short tax year.

Background

A shareholder of an S corporation can take into account his pro rata share of the S corporation's items of in-

come, loss, deduction, or credit.² However, a shareholder may deduct his share of the S corporation's losses only to the extent of his adjusted basis in his stock of the S corporation,³ and the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder.⁴ Any S corporation losses so limited may be carried forward indefinitely.⁵

Tax Court

The Tax Court held that the notes to BNC, the REMC debt, and the short-term debt were not debt of MRRC to Donald and Loren and, therefore, did not provide the additional basis they needed to claim their distributive shares of MRRC's losses. The court outlined certain principles relating to a shareholder's adjusted basis of any indebtedness of an S corporation and the situations under which a shareholder acquires basis with respect to indebtedness.

To qualify as a debt, a shareholder must make an actual economic outlay.⁶ The economic outlay must leave the taxpayer "poorer in a material sense" in order for it to be respected as debt.⁷ In addition, the S corporation's indebtedness must run directly to the shareholder; indebtedness to a passthrough entity that advanced the funds and is closely related to the taxpayer does not satisfy the statutory requirements.⁸ Furthermore, no form of indirect borrowing, be it a guaranty, surety, accommodation, co-making or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the existing obligation. Before that crucial act, "liability" may exist, but not debt to the shareholders.⁹

The court first analyzed the MRRC notes Donald and Loren cosigned and guaranteed to BNC. It said that neither Donald nor Loren was required to make any payments with respect to the notes. In the absence of any discernable economic outlay, the court concluded that Donald and Loren's cosigning and guaranteeing of the notes did not give rise to "indebtedness of the S corporation to the shareholder." Further, cosigning and guaranteeing the notes did not create an indebtedness running directly from MRRC to Donald and Loren. MRRC's only indebtedness ran to BNC. The mere possibility that MRRC could become obligated to Donald and Loren at some future time was irrelevant for purposes of determining indebtedness of the S corporation to the shareholder. Accordingly, Donald and Loren did not obtain basis in the MRRC notes.

As to the REMC debt, the court noted that the money was originally lent to MRRC in April 1996, by REMC, a C corporation owned by Donald and Loren. It said that a loan to an S corporation by another entity owned by the S corporation's shareholder is not an indebtedness of the S corporation to the shareholder. Although the REMC debt was eventually reclassified on MRRC's books on June 30, 1998, as notes payable to Donald and Loren,

there was no evidence suggesting that this treatment was intended at the time REMC made the loans. Standing by itself, the court said, this adjustment of a journal entry several years after the actual transaction was insufficient to reclassify the source of a loan. Because the REMC debt did not run directly to Donald and Loren, it did not increase their bases in MRRC.

Finally, the court rejected Donald and Loren's claim that the short-term debt constituted a series of back-to-back loans from the RGC partnership to Donald and Loren and from Donald and Loren to MRRC. Instead, the court agreed with the IRS that the short-term debt should be classified as a direct loan from the RGC Partnership to MRRC. The court said that the only evidence supporting Donald and Loren's characterization consisted of the short-term notes themselves and the August 31, 1997, adjusting journal entry to MRRC's books reclassifying the short-term debt. The court said the four short-term notes had little probative value as nothing in the record indicated that they were executed contemporaneously with the advances to MRRC. Although each short-term note had an effective date identical to the date on which the RGC partnership made a corresponding advance to MRRC, Donald and Loren's signatures on the notes were not dated, and they failed to present evidence indicating when the notes were executed.

Donald and Loren's reclassification of the short-term debt on MRRC's books was insufficient by itself to prove the loans' origin. The reclassification occurred on the last day of MRRC's final tax year and only one day before the Code Section 351 transaction. Donald and Loren offered no explanation for the timing of the reclassification. Not being contemporaneous with the actual advances, the adjusting journal entry did not establish that the short-term debt constituted back-to-back loans at the time the advances were made.

Finally, none of the interest paid on the short-term debt was included in gross income or deducted as an expense by Donald or Loren. For these reasons, the court said the short-term debt was best characterized as a series of loans from the RGC partnership to MRRC. It was not an economic outlay by MRRC's shareholders, and did not create basis in MRRC stock.

Notes

- 1/ T.C. Memo. 2008-246 (10/30/08).
- 2/ Code Section 1366(a).
- 3/ Code Section 1366(d)(1)(A).
- 4/ Code Section 1366(d)(1)(B).
- 5/ Code Section 1366(d)(2).
- 6/ *Underwood v. Commissioner*, 535 F.2d 309 (5th Cir. 1976).
- 7/ *Perry v. Commissioner*, 54 T.C. 1293 (1970); see also *Bergman v. United States*, 174 F.3d 928 (8th Cir. 1999).
- 8/ *Frankel v. Commissioner*, 61 T.C. 343 (1973), aff'd, without published opinion 506 F.2d 1051 (3d Cir. 1974).
- 9/ *Raynor v. Commissioner*, 50 T.C. 762 (1968).