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S Corporation Loss Limitations: The Tax Court Provides Potential Hope For Related Party Debt Restructurings

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S CORPORATION LOSS LIMITATIONS: THE TAX COURT PROVIDES POTENTIAL HOPE FOR RELATED PARTY DEBT RESTRUCTURINGS

*Francine J. Lipman**

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“The fact that the incidences of income taxation may have been taken into account by arranging matters one way rather than another, so long as the way chosen was the way the law allows, does not make a transaction something else than it truly is.”¹

I. INTRODUCTION

As the economy continues to experience a downturn and business operating losses appear increasingly likely, investors in pass-through entities will want to structure their business entity investments to maximize any possible tax benefits. Taxpayers seeking (1) a business entity that enjoys pass-through treatment of operating and capital losses, (2) one level of tax at the recently reduced individual income tax rates,² and (3) limited liability for investors, generally choose between the S corporation and the limited liability company (LLC). This article will focus primarily on the legal treatment of debt restructurings in the context of S corporations.

II. INTRODUCTION TO BASIC RULES FOR LOSS LIMITATIONS: S CORPORATIONS

Under the loss allowance rules for S corporations and LLCs, a taxpayer's share of deductible business entity losses is generally limited to the taxpayer's tax basis in the enterprise.³ The measurement of tax basis for

¹ Felix Frankfurter, *As Certain as Death – Quotations About Taxes (Expanded 1997 Edition)*, 77 TAX NOTES 1485, 1509 (1997).

² In the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001), Congress made significant marginal tax rate cuts for individual taxpayers. As a result of these decreases, for the first time in years individual average income tax rates will be lower than corporate average income tax rates. The average corporate tax rate for taxable income levels between \$335,000 and \$15,000,000 is 34% and above \$18,333,333 is 35%. See I.R.C. § 11(b). After the changes to the marginal individual income tax rates are fully-phased in by calendar year 2006 and thereafter, the highest individual marginal tax rate will be 35% at approximately \$300,000 of taxable income with marginal tax rates of 10%, 15%, 25%, 28%, and 33% at lower taxable income levels. See I.R.C. § 1, amended by Economic Growth and Tax Relief Reconciliation Act of 2001, *supra*.

³ See I.R.C. §§ 1366(d)(1) (describing loss limitation for each S corporation shareholder as shareholder's adjusted basis in his or her stock in the S corporation plus any indebtedness of the S corporation to the shareholder), 704(d) (describing loss limitation for each partner as the partner's adjusted basis of his or her partnership interest at the end of the partnership year in which the loss occurred); see also I.R.C. §§ 1367 (setting forth adjustments to basis for shareholder's stock basis), 722 (setting forth basis computation for partner's interest in the partnership); Raynor v. Commissioner, 50 T.C. 762, 770-771 (1968).

this purpose, however, is different for an LLC as compared to an S corporation. Each LLC member includes his or her proportionate share of indebtedness of the LLC in the LLC member's tax basis.⁴ Consequently, a member can include his or her share of the LLC's liabilities in the member's tax basis for purposes of determining his or her allowable loss deduction.

In contrast, an S corporation shareholder cannot consider the S corporation's liabilities in determining his or her tax basis because losses from an S corporation are limited to the shareholder's tax basis in his or her stock and any indebtedness of the S corporation to the shareholder.⁵ Any disallowed losses may be carried forward indefinitely until the shareholder has adequate tax basis to absorb these losses.⁶ Nevertheless, disallowed losses cannot be carried over to a buyer, donee, or heir of the S corporation shares.⁷ As a result of the S corporation loss limitation rules, any third-party or indirect shareholder loans to the S corporation cannot be included in any S corporation shareholder's basis. This constraint significantly limits the magnitude of allowable pass-through losses as compared to LLCs and other entities characterized as partnerships.

III. LIMITS ON S CORPORATION LOSS LIMITATIONS

The limitation on S corporation loss deductions has challenged numerous taxpayers and has "sparked serious controversy and criticism in

The fact that shareholders may be primarily liable on indebtedness of a corporation to a third party does not mean that this indebtedness is "indebtedness of the corporation to the shareholder" within the meaning of [the predecessor of Section 1366(d)]. No form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the obligation.

Id.

⁴ A member of an LLC determines her tax basis in her membership interest using the same method as a partner in a partnership uses to determine her tax basis in her partnership interest. See I.R.C. §§ 722, 752(a).

⁵ See I.R.C. § 1366(d)(1)(B).

⁶ See I.R.C. § 1366(d)(2). Until the revisions in the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 2, 96 Stat. 1669, 1677-79, disallowed losses could not be carried forward and were lost forever.

⁷ See I.R.C. § 1366(d)(2) (treating any losses in excess of a shareholder's stock and debt basis as a corporate deduction "with respect to that shareholder" in the corporation's following taxable year); see also Priv. Ltr. Rul. 95-52-001 (Aug. 31, 1995) (interpreting the statutory language "with respect to that shareholder" to mean excess losses are personal to the shareholder and cannot be transferred in any manner).

the last decade among practitioners, the judiciary, and the Internal Revenue Service”⁸ (Service). S corporation shareholders have attempted to minimize this constraint and increase their loss limitations by creative characterizations of debt structures that often include variations of shareholder-level guarantees, indirect shareholder loans, or back-to-back loans. The Service has contested successfully many of these structures because the courts have typically held that S corporation shareholder basis does not include any third-party debt.⁹ In particular, the Service and the courts have strictly construed the loss allowance rules in cases in which shareholders have structured loans among and between themselves and their related entities.

This article discusses the existing authority in this area by focusing on the Service’s and the courts’ strict construction of the law with respect to related party debt restructurings. In *Culnen v. Commissioner*,¹⁰ the Tax Court expressly stated that it would not automatically disallow basis when borrowed funds originate with a related entity.¹¹ The Tax Court’s analysis of the requirements for shareholder basis in *Culnen*, however, is inconsistent with both its analysis in prior decisions and the Service’s absolute denial of basis with respect to related party debt restructurings.¹² This article attempts to analyze and reconcile the Tax Court’s decisions in *Culnen*¹³ and *Yates v. Commissioner*,¹⁴ a later complementary case, with

⁸ Richard L. Winston, *Shareholder Guarantees of S Corporation Debt: Matching the Tax Consequences With Economic Reality*, 81 VA. L. REV. 223, 224 (1995).

⁹ See *Bergman v. United States*, 174 F.3d 928, 934 (8th Cir. 1999) (holding back-to-back loans did not result in shareholder basis because the loans were not shareholder loans but rather third-party loans); *Reser v. Commissioner*, 112 F.3d 1258, (5th Cir. 1997) (holding jointly executed loan documents did not give rise to shareholder basis because loans were not shareholder loans but rather third-party loans with shareholder guarantees); *Harrington v. United States*, 605 F. Supp. 53 (D. Del. 1985) (rejecting taxpayers’ argument that a note signed by them and their corporation was a shareholder loan rather than a third-party loan to the S corporation).

¹⁰ 79 T.C.M. (CCH) 1933 (2000), *rev’d on other grounds*, 89 A.F.T.R.2d (RIA) 383 (3d Cir. 2002) (stating that the court did not say that “the fact that the borrowed funds originate with the closely related entity precludes the indebtedness of the S corporation from running directly to the shareholder”).

¹¹ See 79 T.C.M. (CCH) at 1936-37.

¹² See Tech. Adv. Mem. 94-03-003 (Sept. 29, 1993) (expressing the Service’s hostile attitude toward loan restructurings between related entities); see also *Bhatia v. Commissioner*, 72 T.C.M. (CCH) 696 (1996) (assessing substantial understatement of tax penalty because taxpayer should have been aware of court’s position where the lender is not an adverse party); Stephen R. 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 (1995).

¹³ 79 T.C.M. (CCH) 1933.

the preceding case law.

This article begins with a discussion of the current state of the law of S corporation shareholder basis, shareholder guarantees, and similar structures. Part B and Part C discuss the case law considering S corporation shareholder basis for back-to-back loans and loan substitution transactions, respectively. Part D presents the case law in the area of S corporation shareholder basis for related party debt restructurings. Finally, the article analyzes the recent Tax Court memorandum decisions, *Culnen*¹⁵ and *Yates*,¹⁶ in the context of the relevant historical precedents.

A. Denial of Basis for Shareholder Guarantees and Similar Structures

S corporation shareholder guarantees to third-party lenders in loss S corporations are common, probably because lenders demand a viable source to secure their loans. Even if an S corporation shareholder personally guarantees a third-party loan, however, the courts uniformly have refused to increase the shareholder's basis in either her S corporation indebtedness or stock.¹⁷

The Tax Court's and the Fourth Circuit's holdings in *Estate of Leavitt v. Commissioner*¹⁸ represent the majority rule; that is, there is no basis increase for S corporation shareholder guarantees.¹⁹ In *Leavitt*, the Fourth Circuit, in affirming the Tax Court, refused to accept an S corporation shareholder's position that a third-party loan guaranty was, in substance, equity in the S corporation.²⁰ Alternatively, the *Leavitt* court also refused to accept that the third-party loan was, in substance, debt from the

¹⁴ 82 T.C.M. (CCH) 805 (2001).

¹⁵ 79 T.C.M. (CCH) 1933.

¹⁶ 82 T.C.M. (CCH) 805.

¹⁷ See *Brown v. Commissioner*, 706 F.2d 755, 756 (6th Cir. 1983), *aff'd* 42 T.C.M. (CCH) 1460 (1981); see also *Perry v. Commissioner*, 47 T.C. 159, 163 (1966), *aff'd*, 392 F.2d 458 (8th Cir. 1968); *Raynor v. Commissioner*, 50 T.C. 762, 769 (1968). But see *Selfe v. United States*, 778 F.2d 769, 774 (11th Cir. 1985) (applying debt-equity analysis to guaranteed loans to determine if shareholder's debt was, in substance, equity).

¹⁸ 875 F.2d 420 (4th Cir. 1989), *aff'd* 90 T.C. 206 (1988), *cert. denied*, 493 U.S. 958 (1989).

¹⁹ See *Uri v. Commissioner*, 949 F.2d 371 (10th Cir. 1991); see also *Harris v. United States*, 902 F.2d 439 (5th Cir. 1990); *Keech v. Commissioner*, 65 T.C.M. (CCH) 1986 (1993); *Nigh v. Commissioner*, 60 T.C.M. (CCH) 91 (1990).

²⁰ See 875 F.2d at 423. This refusal has been followed by the Tax Court in all circuits except the Eleventh Circuit where the court applied a debt-equity analysis to guaranteed loans to determine if the shareholder's debt was, in substance, equity in the S corporation. See *Selfe*, 778 F.2d at 774. HeinOnline -- 22 Va. Tax Rev. 71 2002-2003

corporation to the shareholders.²¹ The courts applied the judge-made blackletter law and determined that, absent shareholder payments on the guaranty, there was no increase in shareholder tax basis for a shareholder guaranty.²²

In an opinion predating *Leavitt* by four years, the Eleventh Circuit presented the minority rule in *Selfe v. United States*.²³ In *Selfe*, the court held that an S corporation shareholder who issues a guaranty on S corporation debt is entitled to a basis increase “where the facts demonstrate that, in substance, the shareholder has borrowed funds and subsequently advanced them to her corporation.”²⁴ The Eleventh Circuit has continued to apply this analysis to shareholder guaranty basis matters, but has distinguished guarantees from situations in which the taxpayer has not established that he or she is the borrower and the primary obligor on the loan and the loan proceeds were contributed to the S corporation as an equity capital investment.²⁵ No other circuit court has followed the Eleventh Circuit’s analysis for shareholder guarantees.²⁶ Moreover, the Tax Court has assessed negligence penalties and the substantial understatement penalty on taxpayer deficiencies when it perceives that the taxpayers have inappropriately relied on *Selfe*.²⁷

²¹ See 875 F.2d at 423, *aff’d* 90 T.C. at 212.

²² See *id.*; see also JAMES S. EUSTICE & JOEL D. KUNTZ, FEDERAL INCOME TAXATION OF S CORPORATIONS ¶ 9.05[2][i] (3d ed. 1993) (citing approximately thirty cases for this proposition); PETER M. FASS & BARBARA S. GERRARD, THE S CORPORATION HANDBOOK § 4.01[1][b] (1998) (stating that there have been a stream of Tax Court cases denying shareholder basis for S corporation shareholder guarantees).

²³ 778 F.2d 769 (11th Cir. 1985).

²⁴ *Id.* at 773.

²⁵ See *Sleiman v. Commissioner*, 187 F.3d 1352, 1357 (11th Cir. 1999) (quoting *Selfe*, 778 F.2d at 774, to support the Eleventh Circuit’s position that a guaranty “may be treated for tax purposes as an equity investment in the corporation where the lender looks to the shareholder as the primary obligor”), *aff’d* 74 T.C.M. (CCH) 1270 (1997).

²⁶ See *Leavitt*, 875 F.2d 420 (rejecting the argument made in *Selfe* that the loan was made, in substance, to the shareholders, who then made capital contributions to the corporation); see also *Ellis v. Commissioner*, 57 T.C.M. (CCH) 677 (1989), *aff’d*, 1991 U.S. App. LEXIS 14989 (4th Cir. July 12, 1991) (rejecting arguments made successfully in *Selfe*); *Goatcher v. United States*, 944 F.2d 747 (10th Cir. 1991) (rejecting arguments made successfully in *Selfe*); *Uri v. Commissioner*, 946 F.2d 371 (10th Cir. 1991) (rejecting arguments made successfully in *Selfe*); *Harris v. United States*, 902 F.2d 439 (5th Cir. 1990) (rejecting arguments made successfully in *Selfe*); *Allen v. Commissioner*, 100 F.3d 961 (9th Cir. 1996) (rejecting arguments made successfully in *Selfe*); *Bergman v. United States*, 174 F.3d 928, 934 (8th Cir. 1999) (rejecting arguments made successfully in *Selfe*).

²⁷ See *Briggs v. Commissioner*, 80 T.C.M. (CCH) 870, 885 (2000) (stating that these Eleventh Circuit taxpayers’ reliance on *Selfe* was misplaced and that the case was “so dissimilar that they must be discarded as providing no substantial authority for the tax

Accordingly, the Service and the courts, outside of the Eleventh Circuit, apply the *Leavitt* majority rule that a shareholder's guaranty of an S corporation's loan cannot increase the shareholder's S corporation stock basis absent an economic outlay by the shareholder.²⁸ The strength of this position has resulted in several courts performing an analysis of various taxpayer debt structures and finding the structures to be economically analogous to a shareholder guaranty.²⁹ Not surprisingly, any recharacterization as a guaranty has resulted in the absolute denial of basis for these S corporation shareholders.³⁰

B. Back-to-Back Loan Transactions

The courts and the Service have allowed shareholder debt basis for back-to-back loan and loan substitution transactions that result in indebtedness of the S corporation to the shareholder. The Tax Court has

returns filed in this case") (quoting *Osteen v. Commissioner*, 62 F.3d 356, 360 (11th Cir. 1995)); see also *Reser v. Commissioner*, 70 T.C.M. (CCH) 1472, 1478-79 (1995), *rev'd in part on other grounds*, 112 F.3d 1258 (5th Cir. 1997); *Keech v. Commissioner*, 65 T.C.M. (CCH) 1986, 1990-1991 (1993); *Nigh v. Commissioner*, 60 T.C.M. (CCH) 91, 95 (1990); *Russell v. Commissioner*, 59 T.C.M. (CCH) 492, 494-95 (1990); *Suisman v. Commissioner*, 58 T.C.M. (CCH) 751, 752 (1989). But see *Wise v. Commissioner*, 73 T.C.M. (CCH) 2324, 2332 (1997) (holding that while the facts from *Selfe* were distinguishable, *Selfe* was substantial authority for the petitioners' claim to increase their basis).

²⁸ See *Uri*, 949 F.2d 371; see also *Harris*, 902 F.2d 439; *Keech*, 65 T.C.M. (CCH) at 1990-91; *Nigh*, 60 T.C.M. (CCH) at 95. But see *Selfe*, 778 F.2d at 774.

²⁹ See *Grojean v. Commissioner*, 248 F.3d 572, 573-74 (7th Cir. 2001) (discussing *Avery Wiener Katz, An Economic Analysis of the Guaranty Contract*, 66 U. CHI. L. REV. 47, 113-14 (1999) and *Franco Modigliani & Merton H. Miller, The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 361 (1958) in its analysis of the taxpayer's participation agreement), *aff'd* 78 T.C.M. (CCH) 1249 (1999); see also *Bergman*, 174 F.3d at 932-33; *Reser*, 112 F.3d at 1264; *Wilson v. Commissioner*, 62 T.C.M. (CCH) 1122, 1126 (1991).

³⁰ See *Underwood v. Commissioner*, 63 T.C. 468, 475-76 (1975), *aff'd*, 535 F.2d 309 (5th Cir. 1976) (reasoning that a shareholder's debt restructuring among controlled corporations merely created a shareholder guaranty); *Roesch v. Commissioner*, 57 T.C.M. (CCH) 64 (1988) (denying basis for mere guaranty of S corporation's debt to bank); *Harrington v. Commissioner*, 605 F. Supp. 53 (D. Del. 1985) (denying basis because shareholder debt was characterized as shareholder guaranty); *Wilson*, 62 T.C.M. (CCH) at 1125 (denying shareholder basis for distributions of corporate debt); *Ellis*, 57 T.C.M. (CCH) 677 (holding that taxpayer basis was not increased when he substituted his personal note for corporate indebtedness because the shareholder did not make a cash or property transfer to his S corporation); *Bader v. Commissioner*, 52 T.C.M. (CCH) 1398, 1401 (1987) ("No form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the obligation." (citing *Raynor v. Commissioner*, 50 T.C. 762, 770-771 (1968))).

approved of stock basis increases for direct shareholder loans to S corporations when the shareholders have borrowed the loan proceeds from a third-party lender immediately before the shareholders made loans to an S corporation.³¹ For example, the taxpayers in *Raynor v. Commissioner* owned and operated several bowling alleys, with each belonging to a separate S corporation.³² Several of these S corporations generated operating losses and the shareholders argued that their pass-through losses were not limited by their tax basis because of their shareholder loans and guarantees.³³ While the Tax Court denied basis for any form of indirect borrowing, “through guaranty, surety, accommodation, comaking or otherwise,” the Tax Court nevertheless allowed basis when the shareholders had borrowed funds from a bank and then loaned the same funds to their S corporations.³⁴ The Tax Court found that back-to-back loans resulted in “indebtedness of the corporations to the shareholders” for the purpose of computing their loss limitations.³⁵

The Service also found that shareholders had basis in their S corporation loans, which arose as a result of the shareholders’ year-end debt restructuring. In Technical Advice Memorandum 8443002, the Service addressed a situation in which an S corporation had borrowed money from a bank for use in its car rental business.³⁶ The bank notes were guaranteed by the shareholders and secured by the S corporation’s assets.³⁷ At the end of the year, the shareholders decided that in order to provide more shareholder basis for their pass-through losses, they would restructure the S corporation’s existing bank debt.³⁸ The shareholders proposed that they would borrow money from the same bank by executing personal bank notes, and that they would then loan the same proceeds to their S corporation.³⁹ The S corporation would then use the loan proceeds from the

³¹ See *Raynor*, 50 T.C. at 771; see also *Gilday v. Commissioner*, 43 T.C.M. (CCH) 1295, 1297 (1982) (holding that the substitution of S corporation shareholders’ personal note to the bank for S corporation note guaranteed by shareholders resulted in tax basis for obligated S corporation shareholders).

³² See 50 T.C. at 763.

³³ See *id.* at 768.

³⁴ *Id.* at 771.

³⁵ *Id.*

³⁶ Tech. Adv. Mem. 84-43-002 (July 6, 1984) (stating that back-to-back loans with security interest in corporate assets would meet shareholder requirements under the Code section 465 at-risk rules); see also Prop. Treas. Reg. § 1.465-10(d), 44 Fed. Reg. 32240 (June 5, 1979) (supporting back-to-back loans for at-risk purposes).

³⁷ See Tech. Adv. Mem. 84-43-002 (July 6, 1984).

³⁸ See *id.*

³⁹ See *id.*

shareholders to satisfy its obligation on its bank loan.⁴⁰ Even though the bank did not release its security interest in the S corporation's assets, the Service found that the year-end debt restructuring had created indebtedness from the S corporation to the shareholders providing basis.⁴¹

C. Loan Substitution Transactions

Corresponding to its treatment of back-to-back loans, the Service has ruled that a shareholder received basis for the substitution of a personal promissory note for the S corporation's promissory note. Specifically, in Revenue Ruling 75-144,⁴² after three years of loan payments, a taxpayer's S corporation defaulted on its promissory note to a bank.⁴³ To satisfy the S corporation's obligation, the shareholder executed her own promissory note to the bank.⁴⁴ The bank accepted the shareholder's personal note in full substitution for the S corporation's obligation and relieved the S corporation's liability under its cancelled note.⁴⁵ As a result of this note substitution, the Service determined that the S corporation became indebted to the shareholder under the applicable state law doctrine of subrogation and the shareholder obtained basis for her indebtedness to the corporation.⁴⁶

The Tax Court expanded on the Service's analysis in Revenue Ruling 75-144 in *Gilday v. Commissioner*.⁴⁷ In *Gilday*, the shareholders substituted their personal notes for their S corporation's notes eight months after an initial corporate borrowing.⁴⁸ The shareholders acknowledged that they had structured the substitution in order to create shareholder basis, which would consequently increase their loss limitations.⁴⁹ The Tax Court found that even if state law subrogation did not occur, the substitution transaction created a valid corporate debt to the shareholders and therefore increased their S corporation basis.⁵⁰ The critical point was that the shareholders "moved from positions as guarantors of corporate debt to positions as primary obligors."⁵¹

⁴⁰ See *id.*

⁴¹ See *id.*

⁴² Rev. Rul. 75-144, 1975-1 CB 277.

⁴³ See *id.*

⁴⁴ See *id.*

⁴⁵ See *id.*

⁴⁶ See *id.*

⁴⁷ 43 T.C.M. (CCH) 1295 (1982).

⁴⁸ See *id.* at 1296.

⁴⁹ See *id.*

⁵⁰ See *id.* at 1297.

⁵¹ *Id.*

In Private Letter Ruling 8747013,⁵² the Service allowed two S corporation shareholders (each owning forty-five percent of the corporation) to increase their basis for back-to-back loans, which simply replaced existing S corporation bank debt.⁵³ The S corporation had borrowed monies from a bank, for which the corporation had collateralized its assets and the shareholders had provided personal guarantees.⁵⁴ Under *Leavitt*, this structure would not result in any basis for the S corporation shareholders.⁵⁵ To remedy this problem, the S corporation shareholders borrowed funds personally from the same bank and immediately loaned the proceeds to their S corporation.⁵⁶ Subsequently, the S corporation repaid the bank and was discharged from its obligation.⁵⁷ The S corporation continued to provide collateral for the shareholder bank loans, which was supplemented by the shareholders' pledges of their S corporation stock.⁵⁸ The Service determined that after the debt restructuring, the S corporation shareholders would be the primary obligors on the bank loan and the S corporation had a legal obligation to the S corporation shareholders.⁵⁹ As a result of this "direct obligation" from the S corporation to its shareholders, the shareholders had basis in their S corporation loans.⁶⁰

While the foregoing authorities provide some guidance for S corporation shareholders desiring basis for their S corporation loans, more recent cases and Service pronouncements have obfuscated the treatment of such transactions. For example, in 1991, the Tax Court in *Wilson v. Commissioner*⁶¹ disallowed shareholder debt basis when the shareholders restructured their S corporations' loans to create direct loans to their loss S corporations.⁶² The shareholders in *Wilson* owned three S corporations that had loans among and between them.⁶³ At the end of the taxable year, it

⁵² Priv. Ltr. Rul. 87-47-013 (Aug. 20, 1987).

⁵³ *See id.*

⁵⁴ *See id.*

⁵⁵ *See Estate of Leavitt v. Commissioner*, 875 F.2d 420, 422 (4th Cir. 1989).

⁵⁶ *See Priv. Ltr. Rul. 87-47-013* (Aug. 20, 1987).

⁵⁷ *See id.*

⁵⁸ *See id.*

⁵⁹ *See id.*

⁶⁰ *Id.*

⁶¹ 62 T.C.M. (CCH) 1122 (1991).

⁶² *See id.* at 1126; *see also Ellis v. Commissioner*, 57 T.C.M. (CCH) 677, 680-81 (1989), *aff'd*, No. 89-2230, 1991 U.S. App. LEXIS 14989 (4th Cir. 1991) (holding that taxpayer basis was not increased when he substituted his personal note for corporate indebtedness because the shareholder did not make a cash or property transfer to his S corporation).

⁶³ *See* 62 T.C.M. (CCH) at 1122-23.

became apparent to the shareholders that two of their S corporations were going to incur losses that would be limited at the shareholder level due to insufficient tax basis.⁶⁴ To avoid this limitation, the shareholders directed their profitable S corporation to distribute, as a dividend and thus pass-through income, the loans receivable from the other two loss S corporations.⁶⁵ As a result, the shareholders held loan receivables to them from each of the loss S corporations.⁶⁶ The profitable S corporation had a history of distributing all of its profits to its shareholders and the distribution of loan receivables was merely an alternative to an equivalent cash distribution.⁶⁷

While the monies were distributed to the shareholders in the form of loan receivables, an alternative but economically similar form would have been to distribute cash to the shareholders who could then loan the distributed proceeds to the loss corporations for promissory notes. The loss S corporations would then have the funds to pay off the loan payables to the profitable S corporation. Thus, at the end of the day, the shareholders would hold promissory notes directly from the loss S corporations and enjoy sufficient tax basis for their pass-through S corporation losses.

The Tax Court, however, held that the shareholders had not made “an actual economic outlay with respect to the loans in question,” because the receipt of the loans by the shareholders “through the distributions of the loans . . . [did] not constitute an economic outlay by [them]”⁶⁸ Additionally, the court concluded that there was no substantial authority for the shareholders’ position and upheld a substantial understatement of tax penalty on the Wilsons’ tax deficiency.⁶⁹ While the economic outlay requirement set forth in *Wilson* emerged from the Tax Court’s opinion in *Leavitt*,⁷⁰ *Leavitt* was not a debt restructuring case, but rather involved the issue of shareholder basis in the context of a shareholder guaranty.⁷¹ In *Leavitt*, the taxpayer made several arguments, including the argument that the guaranty was, in substance, a loan to the taxpayer followed by a capital contribution to the S corporation, which would increase the shareholder’s stock basis.⁷² The Tax Court, however, held that the taxpayer did not make any economic outlay or realize any income to constitute a contribution or

⁶⁴ See *id.* at 1124.

⁶⁵ See *id.*

⁶⁶ See *id.*

⁶⁷ See *id.* at 1123.

⁶⁸ *Id.* at 1126.

⁶⁹ See *id.*

⁷⁰ *Estate of Leavitt v. Commissioner*, 90 T.C. 206 (1988).

⁷¹ See *id.* at 211-12.

⁷² See *id.* at 215.

investment in the S corporation, which would result in shareholder basis.⁷³

Many commentators believe that the Tax Court in *Wilson* misapplied the economic outlay analysis and left taxpayers confused as to why the taxpayers' debt restructuring failed.⁷⁴ In addition, one commentator has stated that the economic outlay analysis from *Leavitt* should not apply to a debt-restructuring matter because the shareholders in *Wilson* were not arguing that their shareholder guaranty was, in substance, equal to an equity investment in the S corporation.⁷⁵ Rather, the *Wilson* shareholders argued that existing S corporation loans were distributed to the shareholders as dividends and effectively were replaced with indebtedness from the loss S corporations to the shareholders.⁷⁶ The Wilsons' argument that the shareholders substituted their promissory note for the S corporation loans is similar to the taxpayer arguments made successfully in *Gilday*.⁷⁷ Nevertheless, neither the court nor the taxpayers cited *Gilday* in their arguments.

The Tax Court's analysis in *Wilson* focuses on two related party debt restructuring cases in which the shareholders reclassified debt between related corporations and the shareholders.⁷⁸ In *Burnstein v. Commissioner*⁷⁹ and *Shebestor v. Commissioner*,⁸⁰ after reviewing the facts and circumstances surrounding the alleged shareholder indebtedness, the court determined that the loans were not, in substance, indebtedness from the S corporation to the shareholders.⁸¹ Therefore, the court concluded that the shareholders had not made an actual economic outlay and denied shareholder basis.⁸² In *Wilson*, the Tax Court similarly denied shareholder basis because it determined that the Wilsons, like the shareholders in

⁷³ See *id.* at 213.

⁷⁴ See FASS & GERRARD, *supra* note 22, § 4.01[1][b].

⁷⁵ See William D. Klein, *Back to Basis: Rationality in Back-to-Back Loan Transactions*, 8 J. S. CORP. TAX'N 235, 241 (1997).

⁷⁶ See *Wilson v. Commissioner*, 62 T.C.M. (CCH) 1122, 1125 (1991).

⁷⁷ *Gilday v. Commissioner*, 43 T.C.M. (CCH) 1295 (1982) (holding that taxpayer received basis for loan substitution involving loss S corporation and bank); see also *Hitchins v. Commissioner*, 103 T.C. 711 (1994) (citing *Gilday* as providing a method by which the shareholders in *Hitchins* could have obtained basis); Priv. Ltr. Rul. 87-47-013 (Aug. 20, 1987) (ruling that taxpayer received basis for loan substitution involving S corporation and bank even though security interest in corporate assets continued).

⁷⁸ See 62 T.C.M. (CCH) at 1126 (analogizing facts in *Burnstein v. Commissioner*, 47 T.C.M. (CCH) 1100 (1984), and *Shebestor v. Commissioner*, 53 T.C.M. (CCH) 824 (1987), to *Wilson*).

⁷⁹ 47 T.C.M. (CCH) 1100.

⁸⁰ 53 T.C.M. (CCH) 824.

⁸¹ See *Burnstein*, 47 T.C.M. (CCH) at 1106; *Shebestor*, 53 T.C.M. (CCH) at 827.

⁸² See *Burnstein*, 47 T.C.M. (CCH) at 1106; *Shebestor*, 53 T.C.M. (CCH) at 827.

Burnstein and *Shebester* who were also trying to restructure their related party loans, had not made an actual economic outlay.⁸³ The Tax Court, however, made this determination without any analysis of the facts regarding the form and substance of the loans distributed to the shareholders in *Wilson*.⁸⁴ On a fundamental level, the proper analysis under the Internal Revenue Code (Code) is not whether there is an actual economic outlay, but whether the shareholder loans are valid and constitute direct indebtedness from the S corporation to the shareholders.

Moreover, even if the Tax Court properly applied the economic outlay analysis, the *Wilson* shareholders arguably made an economic outlay. The shareholders suffered a reduction in the economic value of their profitable S corporation's stock after it distributed valuable assets – its S corporation loan receivables.⁸⁵ Furthermore, the shareholders also recognized and reported the distribution as a dividend, potentially subject to tax as dividend income, capital gain income, or reduction in shareholder stock basis.⁸⁶ Therefore, the distribution of the loans receivable to the shareholders, which reduced the value of their profitable S corporation stock and was recognized as a dividend distribution, was an economic outlay.

As a result of the *Wilson* decision, many questions have arisen regarding the Tax Court's position on debt restructuring and S corporation basis. Would the *Wilson* shareholders have prevailed if they had followed the alternative cash flow structure described above, clearly resulting in indebtedness from the loss S corporations to the shareholders? Did the debt restructuring fail because the original promissory notes were not cancelled and new indebtedness from the loss S corporations was not issued directly to the shareholders, thereby accomplishing a novation?⁸⁷

The Tax Court's confused reasoning in *Wilson* is also inconsistent with its 1994 opinion in *Hitchins v. Commissioner*.⁸⁸ In *Hitchins*, the Tax Court found there was "no question that there was an economic outlay by petitioner"⁸⁹ but concluded that the indebtedness was not directly owed to

⁸³ See *Wilson*, 62 T.C.M. (CCH) at 1128.

⁸⁴ See *id.* Notably, in both *Burnstein* and *Shebester*, the Tax Court performed a comparatively detailed review of the facts and circumstances surrounding the alleged shareholder loans. See *Burnstein*, 47 T.C.M. (CCH) at 1101-02; *Shebester*, 53 T.C.M. at 824-25.

⁸⁵ See FASS & GERRARD, *supra* note 22, § 4.01[1][b].

⁸⁶ See *id.*

⁸⁷ This question should be answered affirmatively by the Tax Court after its decision in *Hitchins v. Commissioner*, 103 T.C. 711 (1994).

⁸⁸ 103 T.C. 711 (1994).

⁸⁹ *Id.* at 716.

the shareholder.⁹⁰ Had the Tax Court properly analyzed the facts in *Wilson*, it might have come to the same conclusion as it did in *Hitchins*. In the latter case, the Tax Court focused on the form of the debt, as opposed to its economic substance.⁹¹

Hitchins was a case of first impression for the Tax Court because the question was not whether the shareholders were the direct (versus indirect) lenders, but rather whether the S corporation, in which the shareholders desired basis, was the direct borrower.⁹² Mr. and Mrs. Hitchins, like the shareholders in *Wilson*, attempted to restructure debt in multiple corporations to provide adequate basis for their pass-through S corporation losses.⁹³ While the Hitchinses accomplished most of the steps toward basis, they missed one or two steps that the Tax Court determined were critical.⁹⁴ First, they loaned money to their C corporation for use in developing a database.⁹⁵ After its development, the database was sold to their newly formed and fifty-percent-owned S corporation.⁹⁶ The S corporation bought the database with cash and also assumed the C corporation's obligation under its promissory note to the Hitchinses.⁹⁷ However, the original promissory note was not cancelled and replaced with a new note to the Hitchinses.⁹⁸

The Tax Court explained that Code section 1366, which sets forth the limitations on loss deductions with respect to basis in S corporations, must be strictly interpreted.⁹⁹ Specifically, this interpretation has meant that any indebtedness of an S corporation to a related party of the shareholder or to a pass-through entity in which the shareholder has a beneficial interest does not give the shareholder basis in the corporate debt.¹⁰⁰ The court found that the Hitchinses were direct creditors of their C corporation and, therefore,

⁹⁰ See *id.* at 716-18 (citing favorably to *Gilday v. Commissioner*, 43 T.C.M. (CCH) 1295 (1982)), as providing a method of creating shareholder basis).

⁹¹ See 103 T.C. at 717-18.

⁹² See *id.* at 716-17.

⁹³ See *id.* at 711-14.

⁹⁴ See *id.* at 718-19.

⁹⁵ See *id.* at 713.

⁹⁶ See *id.*

⁹⁷ See *id.* at 714.

⁹⁸ See *id.*

⁹⁹ See *id.* at 718 (referring to section 1366(d) of the Code).

¹⁰⁰ See *id.* at 715; see also *Burnstein v. Commissioner*, 47 T.C.M. (CCH) 1100, 1103 (1984); *Frankel v. Commissioner*, 61 T.C. 343, 349-50 (1973), *aff'd*, 506 F.2d 1051 (3rd Cir. 1974); *Prashker v. Commissioner*, 59 T.C. 172, 176 (1972); *Robertson v. United States*, 32 A.F.T.R.2d (RIA) 5556 (D. Nev. 1973).

only “creditor-beneficiaries” of their S corporation.¹⁰¹ The court added that the Hitchinses had not made an “investment” in the S corporation,¹⁰² even though the court found there was “no question there was an economic outlay.”¹⁰³

Confusing? Yes, because the court followed up this analysis by suggesting, in dicta, two very formalistic solutions for the Hitchinses’ basis problem.¹⁰⁴ These solutions indicated that although the Hitchinses had satisfied the substance (and thus the “investment” and economic outlay) requirement, they were insufficiently thorough in documenting the form of their transactions.¹⁰⁵ First, the court suggested that the shareholders could have obtained basis if the S corporation had taken the steps to replace the original note with a replacement note to the shareholders, thereby accomplishing a novation, which would have, in turn, relieved the Hitchinses’ C corporation of its liability as primary obligor on the debt.¹⁰⁶ The court indicated that this constructive furnishing of funds to the Hitchinses’ S corporation would be recognized under its opinion in *Gilday*.¹⁰⁷

Second, the Hitchinses could have engaged in back-to-back loans to increase their basis.¹⁰⁸ Specifically, they could have loaned the S corporation the money to buy the database from the C corporation with cash, which would have resulted in direct indebtedness from the S corporation to the Hitchinses. In this manner, this transaction would have provided shareholder basis for the indebtedness from the S corporation to the Hitchinses.¹⁰⁹ Third, to achieve the same economic result, the Hitchinses’ C corporation could have repaid the Hitchinses on their original promissory note, which would then be cancelled as paid in full. Arguably, these two scenarios could have been applied to the facts in *Wilson* to achieve basis for those shareholders.

For example, the profitable corporation in *Wilson* could have made a

¹⁰¹ See *Hitchins*, 103 T.C. at 717.

¹⁰² See *id.* (citing to the legislative history of the predecessor statute in which the Senate Finance Committee stated that the amount of the net operating loss apportioned to any shareholder is limited to the adjusted basis of the shareholder’s investment in the corporation, to the adjusted basis of the stock in the corporation owned by the shareholder, and to the adjusted basis of any indebtedness of the corporation to the shareholder).

¹⁰³ *Id.* at 716.

¹⁰⁴ See *id.* at 718-19.

¹⁰⁵ See *id.* at 717.

¹⁰⁶ See *id.* at 718.

¹⁰⁷ See *id.*

¹⁰⁸ See *id.* at 717.

¹⁰⁹ See *id.* at 718.

cash dividend distribution to its shareholders in an amount equal to the total indebtedness owed to it from the two related loss corporations. The shareholders could have loaned immediately the cash to the loss corporations resulting in indebtedness from the loss corporations to the shareholders. The loss corporations could have repaid the profitable corporation the entire amount of their indebtedness. As a result, the shareholders in *Wilson* would hold indebtedness from the loss corporations to the shareholders providing basis. Alternatively, in connection with the profitable corporation's distribution of the loss corporations notes to the shareholders, the notes could have been replaced with notes from the loss corporations to the shareholders. This would have relieved the loss corporations of their obligation to the profitable corporation and replaced it with indebtedness from the loss corporations to the *Wilson* shareholders. The Tax Court in *Hitchins* presented a strained analysis that denied basis allegedly because of a failed investment in the relevant corporation, the loss S corporation, but recommended two rather formalistic resolutions to the basis issue.¹¹⁰

D. Related Party Debt Restructuring

Even more confounding is the Service's traditional position that the source of indebtedness is meaningful only when the third-party lender is an independent party.¹¹¹ The Service has not granted basis to shareholders borrowing from related parties because it believes there has been no economic outlay that would establish genuine indebtedness from the shareholder to the corporation.¹¹² The Tax Court has also denied S corporation shareholder basis in numerous related party debt restructuring cases.¹¹³ More recently, however, the Tax Court stated that "the fact that the borrowed funds originate with the closely related entity" does not preclude the indebtedness of the S corporation from running to the shareholder.¹¹⁴ In fact, the Tax Court has allowed shareholder basis in two different cases for indebtedness to an S corporation where the loan proceeds were transferred directly from the taxpayer's wholly-owned profitable corporation on behalf of the shareholder.¹¹⁵ These decisions are a bit mysterious given the Tax Court's prior decisions in this area, but may evidence the Tax Court's rejection of an excessively formalistic analysis of

¹¹⁰ See *id.* 718-19.

¹¹¹ See Tech. Adv. Mem. 94-03-003 (Sept. 29, 1993).

¹¹² See *id.*

¹¹³ See discussion *supra* Part III.C.

¹¹⁴ *Culnen v. Commissioner*, 79 T.C.M. (CCH) 1933, 1936 (2000).

¹¹⁵ See *id.* at 1938; see also *Yates v. Commissioner*, 82 T.C.M. (CCH) 805 (2001).

related party debt restructuring. The Tax Court appears to be moving in the direction of a more substantive analysis, that is, whether the shareholder loans are valid and constitute direct indebtedness from the S corporation to the shareholders.

In numerous cases of debt restructuring involving wholly-owned and almost wholly-owned corporations, the Tax Court and appellate courts have found that the resulting shareholder loans do not reflect an actual economic outlay entitling the shareholders to increase their basis.¹¹⁶ The Tax Court, in refusing to grant basis, has described such a series of transactions as a “little more than the posting of offsetting book entries, accompanied by the drafting of illusory instruments in commemoration thereof.”¹¹⁷ In light of such a pronouncement, the fact that the shareholders in *Wilson* were attempting to restructure related party debt might have been the true reason for the Tax Court’s denial of shareholder basis.

E. The Related Party Debt Restructuring Case Law Before Culnen v. Commissioner

In two separate tax cases, William and Marion Perry unsuccessfully attempted to create tax basis.¹¹⁸ Pursuant to their 1961 attempt, sometime after their S corporation’s October 31 year end, the Perrys executed and delivered demand promissory notes dated October 31 to their S corporation, and their S corporation, in turn, executed and delivered a long-term promissory note payable to the Perrys for an equal dollar amount.¹¹⁹ Again in 1962, the Perrys issued a new set of demand notes approximately equal to the amount of their S corporation’s 1962 net operating loss.¹²⁰ In both Tax Court cases and the subsequent appeals to the Eighth Circuit Court of Appeals, the courts refused to recognize these transactions as having any economic substance.¹²¹ In the first set of court cases, the Tax Court determined that the Perrys failed to sustain their burden of proving that these notes represented any indebtedness of the corporation to the

¹¹⁶ See, e.g., *Perry v. Commissioner*, 54 T.C. 1293, 1295 (1970), *aff’d*, 27 A.F.T.R.2d (RIA) 1464 (8th Cir. 1971); *Shebester v. Commissioner*, 53 T.C.M. (CCH) 824 (1987).

¹¹⁷ *Perry*, 54 T.C. at 1296; see also *Silverstein v. United States*, 349 F. Supp. 527, 532 (D. La. 1972) (disallowing an increase in tax basis for promissory notes from shareholders for pro rata additional stock).

¹¹⁸ See *Perry*, 54 T.C. 1293, *aff’d*, 27 A.F.T.R.2d (RIA) 1464; *Perry v. Commissioner*, 47 T.C. 159 (1966), *aff’d*, 392 F.2d 458 (8th Cir. 1968).

¹¹⁹ See *Perry*, 47 T.C. at 161.

¹²⁰ See *id.*

¹²¹ See *Perry*, 54 T.C. 1293 (1970), *aff’d*, 27 A.F.T.R.2d (RIA) 1464 (8th Cir. 1971); *Perry*, 47 T.C. at 163, *aff’d*, 392 F.2d at 461.

taxpayers.¹²² In the second set of cases, the court described the facts in the case as yielding “an aroma of alchemist’s brew.”¹²³ The Tax Court held that the notes executed by the Perrys “were, at best, no more than a form of indirect security intended to offer reassurance” to the creditors of the Perrys’ S corporation.¹²⁴ Once again, the court seemed to be analogizing the structure to a guaranty, which would not provide basis.¹²⁵

Similarly, in *Underwood v. Commissioner*,¹²⁶ the Tax Court reasoned and the Fifth Circuit affirmed that a shareholder’s debt restructuring among controlled corporations merely created a shareholder guaranty that would give rise to shareholder basis only if and when the shareholder made a payment on his indebtedness to his corporation.¹²⁷ In *Underwood*, the shareholder owned all of the stock of two S corporations.¹²⁸ When it became apparent that the shareholder did not have sufficient basis for his projected S corporation pass-through losses, he restructured the obligations between the two S corporations as follows: first, the lender corporation surrendered the notes executed by the borrowing S corporation marking them “paid;” second, the borrowing S corporation issued a demand promissory note to the shareholder; third, the shareholder executed a demand note to the lender corporation for the full amount of the original indebtedness.¹²⁹

As a result, the borrowing S corporation was indebted to the shareholder and the shareholder was indebted to the lending corporation.¹³⁰ The Tax Court found that, under the Code, these transactions did not create indebtedness from the S corporation to the shareholders.¹³¹ Because the shareholder had not paid out any funds, and would not do so until his note came due, the courts characterized the structure as indistinguishable from a guaranty.¹³² As a result of this characterization, the Tax Court and the Fifth Circuit denied shareholder basis.¹³³

¹²² See *Perry*, 47 T.C. at 164.

¹²³ *Perry*, 54 T.C. at 1296.

¹²⁴ *Id.* at 1297.

¹²⁵ See *id.*; see also Gilday, 43 T.C.M. (CCH) 1295, 1297 (1982) (stating that when a shareholder is merely a guarantor of S corporation’s debt to a bank, the shareholder has no basis in the debt).

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

¹²⁷ See 63 T.C. at 475-76, *aff’d*, 535 F.2d at 312.

¹²⁸ See 63 T.C. at 468.

¹²⁹ See *id.* at 470.

¹³⁰ See *id.* at 475.

¹³¹ See 63 T.C. at 475, *aff’d*, 535 F.2d at 313.

¹³² See 63 T.C. at 475-476, *aff’d*, 535 F.2d at 312.

¹³³ See 63 T.C. at 477, *aff’d*, 535 F.2d at 313.

Alternatively, if the shareholder had dipped into his own pocket and had made an initial economic outlay of cash as a direct loan to his S corporation, would the courts have found basis? Consider the following “circle of cash” scenario: the S corporation shareholder makes a direct loan to his S corporation, which immediately uses the loan proceeds from its shareholder to pay off its indebtedness to the shareholder’s lending corporation, which immediately uses the loan proceeds to deliver back to the shareholder in exchange for a demand note from the shareholder.

In a dictum, the Tax Court in *Hitchins* suggested that a similar “circle of cash” structure might constitute an economic outlay.¹³⁴ The Hitchinses’ loss S corporation had assumed indebtedness from a related C corporation to the Hitchinses in a legitimate business transaction.¹³⁵ The Tax Court held, however, that this assumption created indirect indebtedness, which did not provide the Hitchinses with basis.¹³⁶ Further, the Tax Court suggested that basis would have been provided by the following “circle of cash” steps: (1) the Hitchinses could have loaned funds to their S corporation in exchange for indebtedness from the S corporation to the Hitchinses; (2) the S corporation could then use the funds to acquire the database from the C corporation; (3) the C corporation could then use the funds to pay off the indebtedness it owed to the Hitchinses.¹³⁷

The shareholders in *Hitchins*, however, as distinguished from the shareholders in *Underwood*, did not hold a loan payable matching their loan receivable.¹³⁸ The *Hitchins* shareholders had used out-of-pocket cash and thus had made an economic outlay.¹³⁹ Their only error, if any, was that their original loan was not to the loss S corporation. The *Underwood* shareholders did not use out-of-pocket cash, but rather held a loan payable to their corporation and a loan receivable from their loss S corporation.¹⁴⁰ The Service, the Tax Court, and the Fifth Circuit found the *Underwood* structure to be analogous to a guaranty and denied shareholder basis.¹⁴¹

Subsequent to the Tax Court’s decisions in *Underwood*, *Wilson*, and *Hitchins*, the Tax Court denied basis for shareholder loans in *Bhatia v. Commissioner*.¹⁴² Moreover, in *Bhatia*, the Tax Court imposed substantial penalties for the understatement of tax liability, stating that the shareholders

¹³⁴ See *Hitchins v. Commissioner*, 103 T.C. 711, 718 (1994).

¹³⁵ See *id.* at 712.

¹³⁶ See *id.* at 715.

¹³⁷ See *id.* at 718-19.

¹³⁸ See *id.* at 714.

¹³⁹ See *id.* at 713.

¹⁴⁰ See *Underwood v. Commissioner*, 63 T.C. 468, 470 (1975).

¹⁴¹ See *id.* at 475-77, *aff’d*, 535 F.2d at 312-313.

¹⁴² 72 T.C.M. (CCH) 696, 699-700 (1996).

should have been aware of the court's position on basis increases for loans when the lender is not an adverse party.¹⁴³ In *Bhatia*, the sole shareholder of an S corporation assumed the S corporation's debt to another corporation, which was also wholly owned by the shareholder.¹⁴⁴ Bhatia evidenced the indebtedness through an executed, formal, written assumption agreement.¹⁴⁵ Bhatia failed to provide the Tax Court with any evidence of issued promissory notes, pledged collateral, interest rate, or repayment schedules.¹⁴⁶ The Tax Court was not convinced based upon Bhatia's "skimpy" evidence that his S corporation was obligated to him.¹⁴⁷

Bhatia argued that Revenue Ruling 75-144 provided substantial authority that the debt assumption provided basis and that he should not be subject to underpayment penalties.¹⁴⁸ The Tax Court distinguished its holding in Revenue Ruling 75-144, noting that the lender in the ruling was an independent bank that would ensure enforcement of the S corporation's obligation.¹⁴⁹ In *Bhatia*, the court found that because the lender was the shareholder's wholly-owned corporation, it was virtually certain that it would never make an "actual economic outlay" sufficient to acquire basis.¹⁵⁰

The Eighth Circuit Court of Appeals followed *Bhatia* in its 1999 decision in *Bergman v. United States*.¹⁵¹ The shareholders in *Bergman* initially sued the government in the District Court in Minnesota and prevailed.¹⁵² The Minnesota District Court stated that the source of the funds the shareholders used to make their S corporation loans was immaterial to the creation of basis.¹⁵³ The Eighth Circuit, however, reasoned that it was not clear whether the shareholder loans were genuine, and that the shareholders had not provided sufficient evidence that they made an economic outlay when the loans were transferred.¹⁵⁴

¹⁴³ See *id.* at 700-01.

¹⁴⁴ See *id.* at 697.

¹⁴⁵ See *id.*

¹⁴⁶ See *id.* at 699.

¹⁴⁷ See *id.* In its opinion, the Tax Court stated that "[c]onceivably, a trial might have provided the necessary flesh on the bones of the transaction involved herein. But petitioners chose to submit this case fully stipulated and must suffer the consequences of their choice." *Id.* at 700.

¹⁴⁸ See *id.* at 699.

¹⁴⁹ See *id.*

¹⁵⁰ See *id.*

¹⁵¹ 174 F.3d 928 (8th Cir. 1999).

¹⁵² See *id.* at 929.

¹⁵³ See *id.* at 931.

¹⁵⁴ See *id.* at 934.

The shareholders in *Bergman* likely paid their tax liability and sued the government in District Court because they already had an unfavorable tax history with the Service as indicated by Technical Advice Memorandum (TAM) 9403003.¹⁵⁵ The TAM involved the Service's denial of basis to a shareholder who restructured his debt among his related entities.¹⁵⁶ The shareholder owned three S corporations.¹⁵⁷ One of the corporations (S1) had a significant bank loan, which it had lent to another of the taxpayer's corporations (S2).¹⁵⁸ To increase the shareholder's loss limitation in S2, S2 repaid its debt to S1, and S1 subsequently loaned the funds to the taxpayer who then lent the funds to S2.¹⁵⁹ As a result, the loss corporation S2 was indebted to the taxpayer.¹⁶⁰ The taxpayer was indebted to S1, and S1 continued to be indebted to the bank.¹⁶¹ The transactions between S2 and the taxpayer were documented by promissory notes.¹⁶² Nevertheless, the Service found that the shareholder had merely exchanged the promissory notes between his controlled S corporations and himself.¹⁶³ The Service, citing *Underwood*, determined that this restructuring did not result in the creation of basis, because the taxpayer had not made "an economic outlay" and was not "poorer in a material sense."¹⁶⁴

The Service distinguished TAM 9403003 from Revenue Ruling 75-144 and *Gilday*, noting that the shareholder in the TAM did not engage in his loan restructuring with an unrelated "arm's length" lender.¹⁶⁵ The original loan proceeds in the TAM, however, were derived from a third-party bank.¹⁶⁶ The critical point was that the shareholder in the TAM did not engage in any direct borrowing from the third-party bank.¹⁶⁷ According to the Service, the shareholder sheltered himself from the third-party debt by inserting a corporation between herself and the third-party lender.¹⁶⁸ After the funds were loaned to the shareholder's corporation, the shareholder borrowed the funds and loaned them to the shareholder's other controlled

¹⁵⁵ See Tech. Adv. Mem. 94-03-003 (Sept. 29, 1993).

¹⁵⁶ See *id.*

¹⁵⁷ See *id.*

¹⁵⁸ See *id.*

¹⁵⁹ See *id.*

¹⁶⁰ See *id.*

¹⁶¹ See *id.*

¹⁶² See *id.*

¹⁶³ See *id.*

¹⁶⁴ *Id.*

¹⁶⁵ See *id.*

¹⁶⁶ See *id.*

¹⁶⁷ See *id.*

¹⁶⁸ See *id.*

entities to provide shareholder basis for loss limitations.¹⁶⁹

In both Revenue Ruling 75-144¹⁷⁰ and *Gilday*,¹⁷¹ on the other hand, the shareholders borrowed directly from a third-party bank.¹⁷² The Service ruled that a shareholder received basis for loans between the shareholders and third-party lenders when the loan proceeds were loaned immediately to the shareholder's controlled S corporations.¹⁷³ Further, the Service has held that if the controlled corporation is the borrower from the third-party lender and the shareholder inserts herself in between the direct borrowing corporation and another controlled loss S corporation, the shareholder will not receive basis.¹⁷⁴ The Service's apparent reasoning was that because the shareholder was protected from liability to any independent third-party lender, she did not make an economic outlay.¹⁷⁵ In TAM 9403003, the Service effectively ignored any shareholder indebtedness if the shareholder inserted herself as borrower and lender between controlled corporations. Therefore, the source of the loan appears to be a critical factor in determining the existence of basis.

Neither the Code nor the Treasury Regulations, however, impose any restrictions on the source of funds that a shareholder loans to an S corporation and requires only that there be "indebtedness of the S corporation to the shareholder."¹⁷⁶ Moreover, the Service's conclusion that the shareholders have not made an economic outlay in genuine restructured debt transactions involving controlled corporations is questionable. The debt arrangements in many related party debt restructurings do not eliminate the possibility that the shareholders will sustain a loss on their shareholder loans. The assumption that no demand for payment will ever be made on these loans is not correct in all cases. If the shareholder or the corporation becomes insolvent or other creditors are in a position to make payment demands, the bankruptcy trustee or other creditors of the insolvent party would take action to enforce any existing shareholder or corporate obligations.

Commentators have stated that the source of the funds for a

¹⁶⁹ See *id.*

¹⁷⁰ Rev. Rul. 75-144, 1975-1 C.B. 277.

¹⁷¹ 43 T.C.M. (CCH) 1295 (1982).

¹⁷² See Tech. Adv. Mem. 94-03-003 (Sept. 29, 1993).

¹⁷³ See *id.*; see also Priv. Ltr. Rul. 98-11-016 (Dec. 3, 1997); Priv. Ltr. Rul. 98-11-017 (Dec. 3, 1997); Priv. Ltr. Rul. 98-11-018 (Dec. 3, 1997); Priv. Ltr. Rul. 98-11-019 (Dec. 3, 1997) (involving back-to-back loans with third-party lenders to shareholders and shareholders to their S corporations).

¹⁷⁴ See Tech. Adv. Mem. 94-03-003 (Sept. 29, 1993).

¹⁷⁵ See *id.*

¹⁷⁶ I.R.C. § 1366(d)(1).

shareholder loan to its S corporation should not be determinative, but that the appropriate analysis is whether there is a genuine obligation from the S corporation to the shareholder.¹⁷⁷ If the S corporation loan represents a genuine obligation from the S corporation to the shareholder, creating an enforceable debtor-creditor relationship between the S corporation and the shareholder under general tax theory, then the Service and the courts should recognize the indebtedness and allow basis. Correspondingly, if the obligation does not represent genuine indebtedness or is a “sham transaction” without any substance under general tax theory, the Service and courts should not recognize the loans as indebtedness and should not allow basis.¹⁷⁸

F. *The Tax Court Begins to Move in the Right Direction*

In view of its 2000 memorandum decision in *Culnen v. Commissioner*,¹⁷⁹ the Tax Court appears to be moving surprisingly in the right direction despite its earlier dispositions of cases involving related party debt restructuring. In *Culnen*, the Tax Court stated that it was attempting to clarify its position with respect to related party borrowings and the question of tax basis for the involved S corporation shareholder.¹⁸⁰ In its opinion, the Tax Court asserted “that the fact that the borrowed funds originate with the closely related entity [does not] preclude the indebtedness of the S corporation from running directly to the shareholder.”¹⁸¹ The Tax Court did note, however, that if the borrowed funds originated with the closely related entity, it would scrutinize the relationship among the parties “to ensure that those relationships comport with the statutory requirement” for creating debt basis.¹⁸²

While *Culnen* is difficult to reconcile with the Tax Court’s prior

¹⁷⁷ See Klein, *supra* note 75, at 242-44; see also John R. Dorocak, *Shareholder Guarantees of S Corporation Debt: Why Not Increase Basis?*, 4 J. S. CORP. TAX’N 56, 79 (1992); Winston, *supra* note 8, at 237.

¹⁷⁸ See *Perry v. Commissioner*, 54 T.C. 1293, 1296 (1970) (stating that the shareholder’s paper shuffling transaction had “an aroma of an alchemist’s brew”).

¹⁷⁹ 79 T.C.M. (CCH) 1933 (2000) *rev’d on other grounds*, 89 A.F.T.R.2d (RIA) 383 (3d Cir. 2002). While the Tax Court concluded that *Culnen* had indeed proven that he had an adequate S corporation basis, it redetermined the amount of the S corporation’s pass-through losses. The Third Circuit Court of Appeals reversed the Tax Court’s decision disallowing a portion of the taxpayer’s S corporation loss because the Tax Court had improperly ruled against the taxpayer based on an issue on which the taxpayer was never advised (namely a last minute challenge to the amount of the S corporation’s loss).

¹⁸⁰ See *id.* at 1936-37.

¹⁸¹ *Id.*

¹⁸² *Id.* at 1937.

opinions in this area, the court expressly pronounced that the Commissioner was “wrong” if he thought, “as a matter of law, direct payments by Culnen & Hamilton [the taxpayer’s wholly-owned profitable corporation] to Wedgewood [the taxpayer’s partially-owned loss S corporation] established Culnen & Hamilton’s status as the investor in Wedgewood.”¹⁸³ In fact, the Tax Court in *Culnen* held for the taxpayer and found that Culnen received basis for his purported S corporation loan, since the loan originated from funds transferred directly by Culnen’s wholly-owned corporation to his jointly-owned loss S corporation.¹⁸⁴

1. *Culnen v. Commissioner*

In *Culnen*, Dan Culnen owned a shareholder interest in Wedgewood Associates, Inc. (Wedgewood), a New Jersey S corporation.¹⁸⁵ Wedgewood owned and operated an unsuccessful restaurant business.¹⁸⁶ As a result, Wedgewood incurred significant losses, which passed through to its shareholders.¹⁸⁷ The Service disallowed Culnen’s pro rata share of Wedgewood’s ordinary losses for 1987, 1989, and 1990 because he failed to convince the Service that he had an adequate basis with respect to his investment in Wedgewood.¹⁸⁸

During the tax years at issue, Culnen’s wholly-owned corporation, Culnen & Hamilton, Inc. (C&H), was an S corporation until it terminated its S corporation status on May 31, 1987.¹⁸⁹ For many years, including the tax years in question (1987, 1989, and 1990), Culnen used C&H as his “incorporated pocketbook, having the corporation make payments on his behalf, which payments were posted to Culnen & Hamilton’s books as loans to [Culnen].”¹⁹⁰ As a result, on almost ninety different occasions for

¹⁸³ *Id.* at 1936. The Tax Court cited to *Hitchins v. Commissioner*, 103 T.C. 711 (1994), which stated “that an indebtedness to an entity with pass-through characteristics that has advanced the funds to the S corporation and is closely related to the taxpayer does not satisfy the statutory requirements” for basis. The *Culnen* Court, however, clarified that the fact the borrowed funds originate with a closely-related entity did not preclude basis. 79 T.C.M. at 1936-37.

¹⁸⁴ See 79 T.C.M. at 1937-38; see also *Yates v. Commissioner*, 82 T.C.M. (CCH) 805 (2001) (holding that the transfers from one wholly-owned corporation to another wholly-owned loss S corporation increased the taxpayers’ basis in their S corporation stock).

¹⁸⁵ 79 T.C.M. (CCH) at 1934. Culnen’s shareholder interest in Wedgewood was 39.48% in 1987; 52% in 1988; and 73% in 1989 and 1990. See *id.*

¹⁸⁶ See *id.*

¹⁸⁷ See *id.* at 1935.

¹⁸⁸ See *id.*

¹⁸⁹ See *id.* at 1934.

¹⁹⁰ *Id.* at 1937.

a total of approximately \$5.8 million, C&H made payments directly to Wedgewood, or paid Wedgewood expenses, or paid monies to a Wedgewood shareholder to acquire his interest all on behalf of Culnen.¹⁹¹

While all of these payments were made directly by C&H with its company checks or wire transfers, all of the amounts were recorded on C&H's books and records and corporate tax returns as loans to Culnen.¹⁹² Moreover, Wedgewood's books, records and S corporation tax returns reflected the payments as loans from Culnen.¹⁹³ Wedgewood's accounting personnel also recorded on Wedgewood's books and records interest payable to Culnen of more than \$600,000.¹⁹⁴

The Tax Court determined that the issue at hand was whether Culnen or C&H had invested in Wedgewood.¹⁹⁵ If the court determined that C&H was the investor, then C&H, not Culnen, would have basis in Wedgewood and the Tax Court would uphold the Commissioner's disallowance of Culnen's Wedgewood losses.¹⁹⁶ To prove that he had invested in Wedgewood, Culnen had to demonstrate that the C&H payments to Wedgewood created indebtedness from Wedgewood to Culnen.¹⁹⁷

The Tax Court admonished the Commissioner for arguing that because the payments to Wedgewood came directly from C&H, Culnen could not claim those amounts in his basis.¹⁹⁸ The Tax Court stated, "[w]e did not say, however, that the fact that the borrowed funds originate with the closely related entity precludes the indebtedness of the S corporation from running directly to the shareholder."¹⁹⁹ The court, however, citing its opinion in *Hitchins*,²⁰⁰ noted that it would "scrutinize the relationships established with respect to the transfer of funds to ensure that those relationships comport with the statutory requirement."²⁰¹

¹⁹¹ See *id.* at 1934-35.

¹⁹² See *id.* at 1935.

¹⁹³ See *id.* at 1934.

¹⁹⁴ See *id.* at 1935.

¹⁹⁵ See *id.* (citing *Prashker v. Commissioner*, 59 T.C. 172, 176 (1972) (stating that "the key question is whether or not the debt of the corporation runs 'directly to the shareholder'")).

¹⁹⁶ See *Culnen*, 79 T.C.M. (CCH) at 1936.

¹⁹⁷ See *id.* (citing *Bolding v. Commissioner*, 117 F.3d 270 (5th Cir. 1997)); see also *Prashker*, 59 T.C. at 176 (stating that if the facts demonstrate that shareholders borrow money personally and then loan the money to the S corporation, the corporation's debt would run directly to the shareholder).

¹⁹⁸ See *Culnen*, 79 T.C.M. (CCH) at 1936.

¹⁹⁹ *Id.* at 1936-37.

²⁰⁰ 103 T.C. 711 (1994).

²⁰¹ *Culnen*, 79 T.C.M. (CCH) at 1937.

In response to the government's plea to analogize the *Culnen* facts to the facts in *Underwood*,²⁰² the court asserted that the issue presented in *Underwood* was distinguishable from the issue presented by Culnen's related party transaction.²⁰³ The court stated that the taxpayer in *Underwood* was a guarantor and, under the long list of cases cited, was not entitled to any basis for his guaranty.²⁰⁴ The court found that the taxpayer in *Underwood* never paid out any funds and would not do so until his note came due; essentially, the taxpayer had only interposed himself between two corporations.²⁰⁵ The court stated, without any explanation, that this was not the case with Culnen.²⁰⁶

The Tax Court was convinced by the testimony of Culnen's witnesses, including two of his accountants.²⁰⁷ The witnesses stated that the payments were made with respect to Culnen's investment in Wedgewood and not for C&H's own investment in Wedgewood.²⁰⁸ The Tax Court seemed convinced by the testimony, the bookkeeping entries to loan payable general ledger accounts, and the consistency of the presentation of the loans on financial statements and tax returns, that Culnen was the lender rather than C&H. Neither the Tax Court nor the government seemed concerned that neither promissory notes nor other supporting or legally enforceable documentation for the indebtedness existed to evidence Wedgewood's indebtedness to Culnen (nor for Culnen's indebtedness to C&H).²⁰⁹

2. *Yates v. Commissioner*

About eighteen months after the Tax Court filed its memorandum decision in *Culnen*, the Tax Court filed a similar pro-taxpayer decision in *Yates v. Commissioner*.²¹⁰ In *Yates*, the court found that direct company-to-company transfers, even though initially recorded as intercompany loans, increased Yates's basis in his wholly-owned S corporation stock.²¹¹ The

²⁰² *Underwood v. Commissioner*, 535 F.2d 309 (5th Cir. 1976), *aff'd* 63 T.C. 468 (1975).

²⁰³ *See Culnen*, 79 T.C.M. (CCH) at 1937.

²⁰⁴ *See id.*

²⁰⁵ *See id.*

²⁰⁶ *See id.*

²⁰⁷ *See id.*

²⁰⁸ *See id.*

²⁰⁹ *Cf. Yates v. Commissioner*, 82 T.C.M. (CCH) 805 (2001) (finding that all transfers were made directly from one wholly-owned corporation to the other and recorded first as company-to-company loans and later as shareholder loans on the books and records).

²¹⁰ 82 T.C.M. (CCH) 805 (2001).

²¹¹ *See id.* at 807. HeinOnline -- 22 Va. Tax Rev. 92 2002-2003

court looked through the form of direct cash transfers from Yates's wholly-owned profitable S corporation, Adena Fuels, Inc. (Adena), to his wholly-owned loss S corporation, Fox Trot Corp. (Fox Trot).²¹² The court determined that loans or distributions to Yates from Adena, followed by Yates's subsequent loan or capital contribution to Fox Trot, constituted the substance of the transfers.²¹³ As a result, Yates had adequate basis in Fox Trot to deduct his disallowed pass-through loss.²¹⁴

The cash transfers from Adena, Yates's successful mining company, financed Fox Trot, Yates's financially unsuccessful Kentucky farm.²¹⁵ Yates's certified public accountant initially recorded the company-to-company cash transfers as "Due to/from Fox Trot" on Adena's books and "Due to/from Adena" on Fox Trot's books.²¹⁶ At the end of the year, the accountant reported the entries as loans or distributions from Adena to Yates on Adena's books and shareholder loans or capital contributions from Yates to Fox Trot on Fox Trot's books.²¹⁷ While Yates did execute a 1994 promissory note bearing five-percent interest to Adena, which was partially repaid in 1995, the accounting and documentation of these related party transfers was not pristine.²¹⁸ The Tax Court noted that Yates paid personal expenses from the Adena bank accounts and used Adena as an

²¹² See *id.*

²¹³ See *id.* at 805-07. The loans to Mr. Yates from Adena were in excess of \$1.5 million and the Adena shareholder distributions were almost \$2.5 million. These amounts were treated as about \$1.9 million of capital contributions to Fox Trot by Mr. Yates and about \$2.1 million in shareholder loans to Fox Trot, giving rise to \$4 million in shareholder basis (of which approximately \$2.8 million was allocable to Mr. Yates and \$1.2 million was allocable to Mrs. Yates). Mr. Yates also prevailed on providing some of the foregoing shareholder basis for his wife, after he transferred his Fox Trot stock to Mrs. Yates. In September of 1994, Mr. Yates gifted all of his Fox Trot stock to his wife, desiring to protect some of his personal assets from any Adena and related-company liabilities. After the stock transfer, Mr. Yates successfully argued that the Adena to Fox Trot transfers were loans or distributions to him, followed by gifts to his wife and her contribution or loan to Fox Trot, which gave rise to S corporation basis in Mrs. Yates's Fox Trot stock. Even though the Yateses skipped one of the steps of circling the cash out from Adena to Mr. Yates and then to Mrs. Yates and then to Fox Trot, the Tax Court was convinced by Mr. Yates's uncontradicted and credible testimony that the transfers gave rise to S corporation stock basis for Mrs. Yates (after September 1994). See *id.*

²¹⁴ The government disallowed the Yateses' pass-through losses from Fox Trot of \$837,556, \$854,372, and \$728,243 for 1994, 1995, and 1996, respectively, resulting in federal income tax deficiencies of \$237,945, \$457,955, and \$172,586, respectively.

²¹⁵ See 82 T.C.M. (CCH) at 805-07.

²¹⁶ See *id.*

²¹⁷ See *id.*

²¹⁸ See *id.*

“incorporated pocketbook.”²¹⁹ Thus, the facts of the *Yates* and *Culnen* cases are very similar and are typical of closely held businesses.

In *Yates*, the Tax Court reiterated the basic rule that “[g]enerally, a shareholder must make an actual economic outlay to increase his basis in an S corporation.”²²⁰ Similar to the Tax Court’s opinion in *Culnen*, however, the court neither discussed the economic outlay requirement nor demonstrated how the taxpayer satisfied it.²²¹ The court, citing its opinion in *Culnen*, implied that *Yates*’s transactions satisfied the requirement by holding that the transactions resulted in S corporation basis.²²²

Adopting the somewhat exasperated tone of the *Culnen* court, the *Yates* court stated, “contentions we have not addressed are moot, irrelevant, or meritless.”²²³ Seemingly bothered by the government’s waste of the court’s time on this matter, the court also noted that *Yates*’s testimony was “uncontradicted and credible.”²²⁴ As in *Culnen*, the Tax Court seemed frustrated with the government’s arguments and lack of evidence. Additionally, while both cases noted the existence of the economic outlay requirement, neither opinion discussed or affirmatively used it to explain or support its holding. In short, the *Yates* case complements the *Culnen* decision and the Tax Court’s position that an S corporation shareholder may receive basis by using funds from his or her related party entities (i.e., “incorporated pocketbooks”²²⁵), even though the form of the contributions are intercompany transfers and bookkeeping entries.

3. Analysis of *Culnen* and *Yates* in the Context of Historical Case Law

In sharp contrast to *Culnen* and *Yates*, the Tax Court in *Hitchins* was troubled by the taxpayers’ failure to achieve a certain level of documentation for their indebtedness and, as a result, denied them any basis in their indebtedness.²²⁶ Specifically, the Tax Court found that because the *Hitchinses*’ original promissory note was not canceled and replaced with a new and direct note, the indebtedness did not run directly from the S corporation to the *Hitchinses*.²²⁷ The court determined that the *Hitchinses*’ profitable corporation and not their loss S corporation remained primarily

²¹⁹ *Id.* at 807.

²²⁰ *Id.*

²²¹ *See id.*

²²² *See id.*

²²³ *Id.*

²²⁴ *Id.*

²²⁵ *Id.*

²²⁶ *See Hitchins v. Commissioner*, 103 T.C. 711, 718-19 (1994).

²²⁷ *See id.* at 717. HeinOnline -- 22 Va. Tax Rev. 94 2002-2003

indebted to the Hitchinses.²²⁸ While the taxpayers in *Hitchins* made a direct and well-documented loan to a related corporation, their loss S corporation assumed the related corporation's loan to the Hitchinses as part of the consideration in an asset sale transaction.²²⁹ Thus, the Tax Court found that the Hitchinses' loss S corporation was an indirect borrower from the Hitchinses, thereby making them indirect lenders to the S corporation.²³⁰

Arguably, Culnen and Yates were indirect lenders as well – lenders through their “incorporated pocketbook[s].”²³¹ The Tax Court could have attempted to distinguish the Hitchinses' S corporation indebtedness from Culnen's S corporation indebtedness, because Culnen always intended to make a personal loan to his loss S corporation. Comparatively, the Hitchinses' original loan was given to their profitable corporation and not to their loss S corporation.²³² Only later, after certain business transactions, did their loan become an obligation to them from their loss S corporation.²³³ In the *Yates* case, Adena, rather than Yates, was the originally recorded lender for certain shareholder items.²³⁴ Only after the end of the year, after Yates's certified public accountant reposted bookkeeping entries and promissory notes were drafted, did the record list Yates as the lender.²³⁵ Similarly, the Tax Court in *Hitchins* did not seem troubled by the fact that the obligor on the indebtedness had changed, but rather that the obligor had not, in fact, been formally changed.²³⁶ The Tax Court held that the loan was not a direct loan, because the Hitchinses had not canceled the original obligation and replaced it with a new direct obligation from their loss S corporation to them.²³⁷ In contrast, the Tax Court in *Yates* and *Culnen* was not concerned with the modifications to the bookkeeping or lack of formal documentation of the indebtedness.²³⁸

While Culnen's loan to Wedgewood was made by C&H on his behalf,

²²⁸ See *id.*

²²⁹ See *id.* at 718.

²³⁰ See *id.* at 718-19.

²³¹ *Yates v. Commissioner*, 82 T.C.M. (CCH) 805 (2001); *Culnen v. Commissioner*, 79 T.C.M. (CCH) 1933, 1934 (2000).

²³² See *Hitchins*, 103 T.C. at 713.

²³³ See *id.* at 714.

²³⁴ See 82 T.C.M. (CCH) at 806.

²³⁵ See *id.*

²³⁶ See 103 T.C. at 717.

²³⁷ See *id.*

²³⁸ See *Yates*, 82 T.C.M. (CCH) at 805; *Culnen v. Commissioner*, 79 T.C.M. (CCH) 1933, 1937-38 (2000).

it was clear that Wedgewood was the borrower.²³⁹ In *Hitchins*, the Tax Court was not convinced that the Hitchinses' loss S corporation was the direct borrower, because of the Hitchinses' failure to document properly the legal relationship between the parties.²⁴⁰ In *Culnen*, the Tax Court was convinced that Culnen, rather than C&H, was the lender.²⁴¹ Culnen and his witnesses proved that Culnen intended to be the lender to Wedgewood at the consummation of the loan.²⁴² In contrast, the Hitchinses acknowledged that they intended to make their original loan to their profitable corporation and not to their loss S corporation.²⁴³ Although the loss S corporation intended to assume the obligation after the original loan was made, the court determined that the assumption was not effective to create a direct obligation from the S corporation to the Hitchinses.²⁴⁴

Culnen and Yates effectively interposed themselves as borrowers and/or distributees from their profitable, wholly-owned corporations and as lenders to their loss S corporations, recalling the actions of the taxpayers in TAM 9403003, *Bergman, Underwood, Wilson*,²⁴⁵ and *Bhatia*. Also, in a manner similar to their predecessors, Culnen and Yates effectively used the cash from their related entities to furnish loan proceeds or capital contributions to their loss S corporations. Unlike the courts or government in each of these matters, however, the Tax Court concluded that the indebtedness generated by the loans provided Culnen and Yates with S corporation shareholder basis.²⁴⁶

In each of these situations, the related entity was originally the lender to the loss S corporation and the S corporation shareholders assumed indebtedness by assuming a related party loan and/or by interposing themselves between the lender corporation and the borrower loss S corporation. In each case, except in *Culnen* and *Yates*, the courts and the government determined that the taxpayer did not make an economic outlay and consequently denied any shareholder basis and, in some cases, assessed penalties. In contrast, the Tax Court never questioned directly whether Culnen or Yates had made an economic outlay. Apparently, because the

²³⁹ See *Culnen*, 79 T.C.M. (CCH) at 1934-35.

²⁴⁰ See *Hitchins*, 103 T.C. at 717-18.

²⁴¹ See 79 T.C.M. (CCH) at 1938.

²⁴² See *id.* at 1937-38.

²⁴³ See *Hitchins*, 103 T.C. at 713.

²⁴⁴ See *id.* at 717-18.

²⁴⁵ The taxpayers in *Wilson v. Commissioner*, 62 T.C.M. (CCH) 1122, 1124 (1991), were not interposed between their two related corporations because they had received their S corporation shareholder indebtedness as a distribution rather than as a loan.

²⁴⁶ See *Yates v. Commissioner*, 82 T.C.M. (CCH) 805, 807 (2001); *Culnen*, 79 T.C.M. (CCH) at 1938.

profitable corporations were making cash payments to the loss S corporations on behalf of shareholders, Culnen and Yates had each made an economic outlay. Nevertheless, like the taxpayers in the other cases, Culnen and Yates either borrowed or took as a distribution the money loaned or contributed from a closely held corporation and immediately loaned the related entity's cash to a loss S corporation.²⁴⁷

The courts and the government found previously that such payments did not give rise to an economic outlay because the loans in question were between related parties and presumably would never be repaid, and therefore, no real indebtedness existed to warrant increasing shareholder basis. Given these earlier interpretations, in what sense did Culnen and Yates make an economic outlay, which rendered them "poorer in a material sense" after the transaction than they were before?²⁴⁸ The Tax Court never discussed the fact that the wholly-owned corporations in these cases might never enforce any outstanding loan. Moreover, the court never analyzed whether Culnen or Yates made an economic outlay, which rendered them "poorer in a material sense," because the loan proceeds were provided to a related entity.

As for *Culnen*, if Wedgewood had borrowed money from C&H, and, subsequently, Culnen assumed Wedgewood's obligation to C&H in exchange for a promissory note from Wedgewood, would the court have found an economic outlay? In the alternative, if Wedgewood had borrowed money from C&H and, subsequently, Culnen acquired C&H's loan receivable from Wedgewood in exchange for his obligation to C&H, would the court have found that there was an economic outlay?²⁴⁹ The Tax Court has not found such an outlay and has denied basis in economically similar transactions in *Wilson*,²⁵⁰ *Bergman*,²⁵¹ *Bhatia*,²⁵² and *Underwood*.²⁵³ Nevertheless, in both *Culnen* and *Yates*, how might the timing of the transactions change the economics?

The timing of the transactions should not affect the economic substance

²⁴⁷ See *Yates*, 82 T.C.M. (CCH) at 805-06; *Culnen*, 79 T.C.M. (CCH) at 1934-35.

²⁴⁸ See *Perry v. Commissioner*, 54 T.C. 1293, 1296 (1970).

²⁴⁹ Alternatively, in *Yates*, 82 T.C.M. (CCH) 805, if the Adena to Fox Trot loans had not been reposted as loans or distributions to Mr. Yates followed by loans or contributions to Fox Trot, but later Mr. or Mrs. Yates had acquired Adena's loan receivable from Fox Trot in exchange for the Yateses' obligation to Adena, would the Tax Court have found an economic outlay?

²⁵⁰ 62 T.C.M. (CCH) at 1126.

²⁵¹ *Bergman v. United States*, 174 F.3d 928, 934 (8th Cir. 1999).

²⁵² *Bhatia v. Commissioner*, 72 T.C.M. (CCH) 696, 699-700 (1996).

²⁵³ *Underwood v. Commissioner*, 63 T.C. 468, 475-76 (1975), *aff'd*, 535 F.2d 309 (5th Cir. 1976).

of the resulting indebtedness. If indebtedness from an S corporation to its shareholder is genuine and enforceable, the sequence of steps of its origination should not be relevant. Therefore, the proper S corporation shareholder basis analysis is not a formalistic review of the timing of the steps constituting the origination of the debt, but an examination as to whether a transaction results in direct, genuine, and enforceable indebtedness from the S corporation to the shareholder. In *Culnen*, the court determined that the taxpayer's witnesses' testimonies and financial statements demonstrated that the order of the rather sloppy transactions was: (1) C&H made a loan to Culnen and (2) Culnen made a loan to Wedgewood;²⁵⁴ versus the alternative characterization of (1) C&H made a loan to Wedgewood followed by (2) Culnen's assumption of Wedgewood's indebtedness to C&H and (3) Wedgewood's issuance of indebtedness to Culnen;²⁵⁵ or (1) C&H made a loan to Wedgewood followed by (2) Culnen's acquisition of the loan receivable from Wedgewood to C&H and (3) Culnen's issuance of indebtedness to C&H.²⁵⁶ The Tax Court could have characterized the origination of Wedgewood's indebtedness to Culnen under either of the foregoing alternative scenarios. The alternative scenarios do not change the substance of the resulting indebtedness. The Tax Court, however, has repeatedly denied shareholder basis under these alternative scenarios using an excessively formalistic approach to related party debt restructuring basis analysis.²⁵⁷

In *Yates*, the original cash transfers were reposted from intercompany loans to company to shareholder loans, distributions, or capital contributions.²⁵⁸ Therefore, arguably the second scenario set forth above

²⁵⁴ This scenario, with one additional step, was unsuccessful in TAM 94-03-003 (Sept. 9, 1993) and later in *Bergman*, 174 F.3d 928. The controlled corporation in the TAM and in *Bergman* borrowed the funds from a bank before it loaned the funds to the shareholder for the subsequent shareholder loan to the loss S corporation. The Service and the Eighth Circuit denied shareholder basis for the indebtedness from the controlled loss S corporation to the shareholder.

²⁵⁵ This alternative scenario was unsuccessful in *Bhatia*, 72 T.C.M. (CCH) 696 (denying basis for shareholder assumption of S corporation's indebtedness to another controlled corporation giving rise to indebtedness from the loss S corporation to Bhatia).

²⁵⁶ This alternative scenario was unsuccessful in *Wilson v. Commissioner*, 62 T.C.M. (CCH) 1122 (1991) (denying basis for dividend distribution by profitable corporation of indebtedness from loss corporation to profitable corporation to shareholders).

²⁵⁷ See *id.* (denying basis for dividend distribution by profitable corporation of indebtedness from loss corporation to profitable corporation to shareholders); *Bhatia*, 72 T.C.M. (CCH) 696 (denying basis for shareholder assumption of S corporation's indebtedness to another controlled corporation giving rise to indebtedness from the loss S corporation to Bhatia).

²⁵⁸ See 82 T.C.M. (CCH) at 805.

could have been the actual form in *Yates*: (1) Adena made a loan to Fox Trot followed by (2) Yates's assumption of Fox Trot's obligation to Adena and (3) Fox Trot's issuance of indebtedness to Yates; or (1) Adena made a loan to Fox Trot followed by (2) Yates's acquisition of the loan receivable from Fox Trot to Adena, and (3) Yates's issuance of indebtedness to Adena.²⁵⁹ In the *Yates* and *Culnen* cases, because the form of the transactions was not precise or well documented, the Tax Court looked through the form to the substance and determined in each case that the economic substance gave rise to shareholder basis.²⁶⁰

As numerous commentators have argued, the economic outlay requirement is misguided and confusing.²⁶¹ If *Culnen* and *Yates* had made an economic outlay, then such an economic outlay could be found in each of *Wilson*,²⁶² TAM 9403003,²⁶³ *Bergman*,²⁶⁴ *Bhatia*,²⁶⁵ and *Underwood*.²⁶⁶

²⁵⁹ A similar scenario was unsuccessful in *Underwood v. Commissioner*, 63 T.C. 468, 475-76 (1975), *aff'd*, 535 F.2d 309 (5th Cir. 1976). In *Underwood*, two controlled corporations inserted the shareholder in the middle of their loan. The lender corporation surrendered the notes executed by the borrowing S corporation marking them "paid;" the borrowing S corporation issued a demand promissory note to the shareholder; and the shareholder executed a demand note to the lender corporation for the full amount of the original indebtedness. The Tax Court and the Fifth Circuit denied shareholder basis for the indebtedness because the shareholder had not paid out any funds.

²⁶⁰ See *id.* at 806-07; *Culnen v. Commissioner*, 79 T.C.M. (CCH) 1933, 1938 (2000).

²⁶¹ See Klein, *supra* note 75, at 242; see also John R. Dorocak, *Shareholder Guarantees of S Corporation Debt: Why Not Increase Basis?*, 4 J. S. CORP. TAX'N 56, 79 (1992); Winston, *supra* note 8, at 237; Looney, *supra* note 12.

²⁶² 62 T.C.M. (CCH) at 1126 (denying basis for dividend distribution of S corporation indebtedness to shareholders). The fact pattern in *Wilson* is similar to an alternative interpretation of the origination of the shareholder indebtedness in *Culnen*, 79 T.C.M. (CCH) 1933. See discussion *supra* note 256 and accompanying text.

²⁶³ Tech. Adv. Mem. 94-03-003 (Sept. 9, 1993) (denying basis for insertion of shareholder as debtor and creditor between controlled corporations where funds originate from bank). The fact pattern in TAM 9403003 is similar to an alternative interpretation of the origination of the shareholder indebtedness in *Culnen*, 79 T.C.M. (CCH) 1933. See discussion *supra* note 255 and accompanying text.

²⁶⁴ *Bergman v. United States*, 174 F.3d 928, 934 (8th Cir. 1999) (denying basis for insertion of shareholder as debtor and creditor between controlled corporations). The fact pattern in *Bergman* is similar to an alternative interpretation of the origination of the shareholder indebtedness in *Culnen*, 79 T.C.M. (CCH) 1933. See discussion *supra* note 255 and accompanying text.

²⁶⁵ *Bhatia v. Commissioner*, 72 T.C.M. (CCH) 696, 699-700 (1996) (denying basis for S corporation's indebtedness to shareholder arising from shareholder's assumption of the S corporation's indebtedness to related corporation). The fact pattern in *Bhatia* is similar to an alternative interpretation of the origination of the shareholder indebtedness in *Culnen*, 79 T.C.M. (CCH) 1933. See discussion *supra* note 250 and accompanying text.

²⁶⁶ *Underwood v. Commissioner*, 63 T.C. 468, 475-76 (1975), *aff'd*, 535 F.2d 309 (5th Cir. 1976).
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The proper analysis is the one arguably applied by the Tax Court in *Hitchins*²⁶⁷ and mentioned by it in *Bhatia*: whether the loan was a valid and genuine “indebtedness of the S corporation to the shareholder.”²⁶⁸ This requirement is expressly stated in section 1366 of the Code.²⁶⁹ Therefore, if a court or the government determines that indebtedness is not authentic because it is not legally enforceable, lacks any credible substance, or is a sham transaction, the taxpayer should not receive any basis for the debt. Additionally, if the indebtedness is not owed to the shareholder, but rather is legally or in substance owed to a party related to the shareholder, then the requirement for basis is not satisfied.²⁷⁰

While the courts or the government in the foregoing matters may have legitimately believed that the taxpayers did not hold enforceable and direct indebtedness from their loss S corporations, in each case the application of the economic outlay requirement was inappropriate and misapplied. The government did not specifically advance the economic outlay argument in *Culnen* and the Tax Court never addressed it in that case.²⁷¹ Perhaps the absence of this discussion in *Culnen*, and subsequently in *Yates*,²⁷² will open the door for successful taxpayer suits for basis in related party debt restructurings.

Like the debt in foregoing matters, existing loans between a lending profitable corporation and a loss S corporation could be legally assumed by the S corporation shareholder and give rise to basis under section 1366 of

Cir. 1976) (denying basis for S corporation indebtedness to shareholder, when shareholder is inserted between controlled corporations as debtor and creditor). The fact pattern in *Underwood* is similar to an alternative interpretation of the origination of the shareholder indebtedness in *Yates v. Commissioner*, 82 T.C.M. (CCH) 805 (2001). See discussion *supra* note 254 and accompanying text.

²⁶⁷ *Hitchins v. Commissioner*, 103 T.C. 711, 717-19 (1994).

²⁶⁸ In *Bhatia*, the court stated that “[h]aving noted the significance of the close relationship where S corporations are involved, we hasten to add that the existence of such a relationship is not necessarily fatal if other elements are present which clearly establish the bona fides of the transactions and their economic impact.” *Bhatia*, 72 T.C.M. (CCH) at 700.

²⁶⁹ I.R.C. § 1366(d)(1).

²⁷⁰ The rules of attribution do not allow contributions by a flow-through or related entity. See, e.g., *Prashker v. Commissioner*, 59 T.C. 172, 177 (1972); *Gurda v. Commissioner*, 54 T.C.M. (CCH) 104 (1987).

²⁷¹ See *Culnen v. Commissioner*, 79 T.C.M. (CCH) 1933 (2000), *rev’d on other grounds*, 89 A.F.T.R.2d (RIA) 383 (3d Cir. 2002).

²⁷² In *Yates v. Commissioner*, 82 T.C.M. (CCH) 805 (2001), the Tax Court noted economic outlay requirements, but otherwise did not address it. It was not clear, however, whether the government raised the argument because the court closed its opinion without addressing the government’s other unnamed contentions as “moot, irrelevant, or meritless.” *Id.* at 807.

the Code.²⁷³ In substance, Culnen and Yates merely interposed themselves between a lending profitable corporation and a borrowing loss corporation. The only distinction between *Culnen* and *Yates* and the prior case law is that *Culnen* and *Yates* may have affected the transaction at the time of the borrowing rather than at a later date.²⁷⁴ Surely, the timing of the steps of the origination of the indebtedness should not impact its legitimacy or enforceability as long as it legally exists and is enforceable as of the end of the tax year in question.

4. Does the Tax Court's Frustration with the Government's Trial Tactics Open the Door for the Success of Shareholder Basis Arguments?

One explanation for the lack of an economic outlay discussion in *Culnen* could be that the Tax Court was dissatisfied with the government's allegedly spurious arguments and did not want to raise substantive arguments that the government did not make. Perhaps the government's approach to the Tax Court trial provided a rare opportunity for Culnen to obtain S corporation shareholder basis where the Tax Court had historically not allowed it. Similarly, in *Yates*, the court stated and cited the economic outlay requirement in one sentence.²⁷⁵ Moreover, the concluding sentence in the *Yates* opinion hints at the court's disdain for and impatience with the government's deficient contentions. The *Yates* court concludes its opinion by stating, "[c]ontentions we have not addressed are moot, irrelevant, or meritless."²⁷⁶

In *Culnen*, the Tax Court was irritated by the fact that the government called no witnesses and introduced no exhibits at trial.²⁷⁷ The court also stated that the government made "unsupported, unpersuasive and offensive attacks on the credibility of Culnen and the ethics of his witnesses."²⁷⁸ The court strongly admonished the government for relying on the tactic of trial by cross-examination and resorting to name-calling as a fallback position.²⁷⁹ Did Culnen therefore prevail as a result of the government's misbehavior and its failure to advance the economic outlay argument?²⁸⁰

²⁷³ See I.R.C. § 1366(d)(1).

²⁷⁴ As noted above, because the Yateses' transactions were so loosely documented, Mr. Yates may have assumed the Adena to Fox Trot loans after origination at the end of the year. See *Yates*, 82 T.C.M. (CCH) 805.

²⁷⁵ See *id.* at 807.

²⁷⁶ *Id.* at 807.

²⁷⁷ See 79 T.C.M. (CCH) at 1938.

²⁷⁸ *Id.*

²⁷⁹ See *id.*

²⁸⁰ Cf. *Yates*, 82 T.C.M. (CCH) 805 (finding that the company-to-company transfers

Despite the shortcomings in the government's argument in *Culnen*, the government did propose that the Tax Court follow *Underwood* as a model.²⁸¹ The Tax Court noted that in *Underwood*, unlike in *Culnen*, the taxpayer did not pay out any funds.²⁸² The Tax Court seemed to ignore, however, that the taxpayers in *Underwood* could have paid out funds. In *Underwood*, the parties to the restructuring took a shortcut and merely adjusted the corporate books and records to reflect the transactions rather than actually funding the cash through the various corporate and shareholder accounts.²⁸³ What is most interesting about the Tax Court's distinction between *Underwood* and *Culnen* is that the taxpayers in *Culnen* also took shortcuts in their cash transactions and merely adjusted the books and records to reflect the intended transactions between C&H and its shareholders.²⁸⁴ In *Culnen*, C&H deposited cash directly in Wedgewood's bank account, and the *Culnen* shareholders did not pay out any funds to the loss S corporation.²⁸⁵ C&H could have paid its shareholder loan proceeds to *Culnen*, and *Culnen* then could have loaned the same money to Wedgewood. Similarly, the shareholder in *Underwood* could have used personal funds to make an initial economic outlay of cash as a direct loan to his S corporation. The S corporation could have then immediately used the loan proceeds to pay off its indebtedness to the shareholder's lending corporation, which in turn could have used the loan proceeds to extend a loan to the shareholder in exchange for a shareholder demand note.

The Tax Court has neither acknowledged nor accepted the similarity of the "circle of cash" argument in *Underwood* and its progeny and *Culnen*. In *Culnen*, however, the court's decision to accept a shortcut of cash flow among related parties without questioning directly the taxpayer's economic outlay²⁸⁶ may indicate the beginning of the end of the economic outlay requirement.²⁸⁷ Moreover, eighteen months later in *Yates*, while the court recited the economic outlay requirement, it does not engage in any

gave rise to shareholder loans providing basis, but concluding its opinion by stating that "[c]ontentions we have not addressed are moot, irrelevant, or meritless").

²⁸¹ See *Culnen*, 79 T.C.M. (CCH) at 1937.

²⁸² See *id.*

²⁸³ See *Underwood v. Commissioner*, 63 T.C. 468, 471 (1975).

²⁸⁴ See *Culnen*, 79 T.C.M. (CCH) at 1934-35.

²⁸⁵ See *id.* at 1934.

²⁸⁶ See *id.* at 1938.

²⁸⁷ Cf. *Shebester v. Commissioner*, 53 T.C.M. (CCH) 824 (1987) (denying shareholder basis where shareholders testified that they intended that monies transferred between related corporations to be shareholder dividends); *Burnstein v. Commissioner*, 47 T.C.M. (CCH) 1100 (1984) (denying shareholder basis despite testimony by shareholders that related party transfers were made on behalf of the shareholders).

discussion of the requirement.²⁸⁸ As a result, the Tax Court may allow shareholder basis in related party debt restructurings where the shareholder is legitimately a party to the lending transactions.

IV. CONCLUSION

The Tax Court's decisions in *Culnen*²⁸⁹ and *Yates*,²⁹⁰ coupled with its opinions in *Hitchins*²⁹¹ and *Bhatia*,²⁹² have begun to lay a foundation for shareholder basis in related party debt restructurings. If shareholders go through the formalities of (1) making cash payments despite the fact that the cash circles back to them and (2) drafting well-documented back-to-back related party loans that constitute enforceable obligations, the Tax Court should respect them. In *Culnen*, and more recently in *Yates*, the Tax Court granted basis, even though the origins of the loan proceeds were unclear and the corporate loans were not well documented.²⁹³ In *Bhatia*, however, the Tax Court did not respect the S corporation shareholder's documented assumption of the S corporation's obligations, which resulted in its denial of basis and assessment of penalties on the tax deficiencies.²⁹⁴ Similarly, in *Hitchins*, the Tax Court denied basis because the debt assumption was not properly documented.²⁹⁵ Moreover, even if the promissory notes are well documented, the Service has ruled that it will deny basis for S corporation loans when the S corporation shareholder has interposed himself between a lending corporation and the borrowing corporation.²⁹⁶ Thus, the Tax Court has laid a provisional foundation for S corporation shareholder basis in related party debt restructurings and provides potential hope for future improvements.

²⁸⁸ See *Yates v. Commissioner*, 82 T.C.M. (CCH) 805 (2000).

²⁸⁹ 79 T.C.M. (CCH) 1933 (2000).

²⁹⁰ 82 T.C.M. (CCH) 805 (2001).

²⁹¹ *Hitchins v. Commissioner*, 103 T.C. 711 (1994).

²⁹² *Bhatia v. Commissioner*, 72 T.C.M. (CCH) 696 (1996).

²⁹³ See *Yates*, 82 T.C.M. (CCH) at 806-7; *Culnen*, 79 T.C.M. (CCH) at 1938.

²⁹⁴ See 72 T.C.M. (CCH) at 699. The *Bhatia* Court was not convinced by the evidence presented by *Bhatia* that the debt assumption had substance and noted that "a trial might have provided the necessary flesh on the bones of the transactions." *Id.* at 700.

²⁹⁵ See 103 T.C. at 716-18.

²⁹⁶ See Tech. Adv. Mem. 94-03-003 (Sept. 9, 1993).

