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S Corporation Shareholders and Entity-Level Indebtedness: Is a Shareholder Ever Allowed to Deduct Losses Against Entity-Level Indebtedness?

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S CORPORATION SHAREHOLDERS AND ENTITY-LEVEL INDEBTEDNESS: IS A SHAREHOLDER EVER ALLOWED TO DEDUCT LOSSES AGAINST ENTITY-LEVEL INDEBTEDNESS?

by

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INTRODUCTION

The owner of a closely-held business does not generally consider the tax implications when it is necessary to obtain financing for his business. A loan is negotiated and the borrowed funds are put to use by the business. However, in the case of a third-party loan to an S corporation,[1] different tax consequences may greet taxpayers conducting business as an S corporation, depending on the form of the loan transaction. Business owners adopting the S corporation form of doing business may discover that operating losses of the entity cannot be deducted due to the form of loan transactions between their corporation and third-party lenders. The purpose of this paper is to discuss the current state of the law with respect to a shareholder's ability to utilize entity-level indebtedness for the purpose of deducting S corporation losses currently.

Prior to the enactment of Subchapter S, a study completed by the Treasury Department in 1946 suggested that treating an electing corporation as a partnership and its shareholders as partners would be appropriate for most closely held corporations.[2] Although technical and administrative considerations argue against the use of the partnership approach for corporations with a large number of shareholders or a complex capital structure, closely held corporations and their shareholders were seen as one economic identity with little real difference (other than the concept of limited liability) from a partnership and its partners.

The legislative history and statutory framework of Subchapter S indicate that the partnership approach was adopted by Congress for the taxation of electing corporations.[3] This legislative history indicates that Congress was interested in providing small business owners the opportunity to choose the form of doing business without regard to the tax consequences.[4] The enactment of Subchapter S was, at least in part, designed to remedy the problem faced by small business owners experiencing operating losses when doing business as a corporation.[5] The losses that would otherwise be trapped in the corporation could, by utilizing the provisions of the newly enacted Subchapters S, be

[1] Reference to Subchapter S refer to 26 U.S.C., Subtitle A, Chapter 1, Subchapter S.

[2] RICHARD B. GOODE, THE POSTWAR CORPORATION TAX STRUCTURE (1946).

[3] Subchapter S provisions specifically refer to provisions applicable to partners and partnerships. For example, I.R.C. § 1372 treats shareholders as partners for purposes of rules regarding employee fringe benefits. I.R.C. § 1372 (1988). *See also* S. REP. NO. 1983, 85th Cong., 2d Sess. (1988), 1958-3 C.B. 922,1008; H.R. REP. NO. 826, 97th Cong., 2d. Sess., at 6 (1982), 1982-2 C.B. 730; S. REP. NO. 640, 97th Cong., 2d. Sess., at 6 (1982), 1982-2 C.B. 718.

[4] S. REP. NO. 1983, 85th Cong., 2d Sess., 1958-3 C.B. 922, 1008.

[5] *Id.*

utilized by the small business owner to offset other taxable income. According to the legislative history, losses generated by the electing subchapter S corporation should be utilized by the shareholders to the extent of their "investment in the corporation."[6] The committee reports state that a shareholder's investment in the corporation includes shareholder loans to the corporation.[7]

Out of this legislative history and statutory framework grew the shibboleth that for tax purposes a shareholder in an S corporation is treated like a partner in a partnership. However, for federal tax purposes shareholders are not treated like partners in all respects. For example, a partner cannot be an employee of the partnership; all operating income of the partnership is taxed to its general partners as self-employment income.[8] Active shareholders in an S corporation, on the other hand, can be treated as employees for purposes of withholding social security and federal income tax from amounts received for services rendered to the corporation. No self-employment tax is due, however, on the shareholder's distributive share of S corporation taxable income.[9] Transfers to an S corporation by a shareholder and distributions from an S corporation to a shareholder are treated differently than similar transactions between a partnership and its partners.[10]

With respect to entity-level debt, significantly different tax consequences greet the S corporation shareholder and a similarly situated partner. In the case of a partner, an increase in his share of partnership liabilities is treated as a contribution of money to the partnership.[11] Thus, an increase in entity-level debt provides a partner with additional tax basis in his partnership interest against which his distributive share of partnership losses can be currently utilized.[12] Like a partner, an S corporation shareholder is allowed to deduct his share of corporate operating losses to the extent of his tax basis in the entity.[13] However, with the exception of a loan from a shareholder to his S corporation, no

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[6] *Id.* at 1141.

[7] *Id.*

[8] I.R.C. § 1402(a) (1988 & Supp. III 1991); Treas. Reg. § 1.1402(a)-1(a)(2) (as amended in 1974).

[9] Rev. Rul. 59-221, 1959-1 C.B. 225. Since a shareholder's distributive share of S Corporation income is not subject to self-employment taxes, the Service is interested in making sure shareholder/employees do not undercompensate themselves in order to avoid employment taxes. As a result, the Service will recharacterize a shareholder's distributive share of S Corporation income as wages when the shareholder is not adequately compensated for his services. Rev. Rul. 74-44, 1974-1 C.B. 287.

[10] *Compare* I.R.C. §§ 351 *and* 357 *with* I.R.C. §§ 721, 752 (with respect to contributions to the entity). I.R.C. §§ 351, 357, 721, 752 (1988 & Supp. III 1991). *Compare* I.R.C. §§ 301, 302 *and* 311 *with* I.R.C. § 731 (with respect to distributions from the entity). I.R.C. §§ 301, 302, 311, 731 (1988).

[11] I.R.C. § 752(a) (1988). A partner's share of partnership debt is not easily determined. *See* Treas. Reg. § 1.752-1 (1956).

[12] I.R.C. §§ 722, 704(d) (1988). A partner's distributive share of partnership loss in excess of the adjusted basis in his partnership interest is disallowed and carried forward until the partner's additional capital contributions, additional partnership income, or additional liabilities provide tax basis in the partner's partnership interest.

[13] I.R.C. § 1366(d) (1988).

increase in basis arises from an increase in corporate-level borrowing.[14] Consequently, a shareholder's distributive share of his corporation's operating loss in excess of his capital contribution may not be currently deducted due to a lack of basis.[15] Whereas had the shareholders chosen the partnership form of doing business, the loss may have been deducted against basis provided by entity-level debt incurred after the initial capital contribution. Many taxpayers, under the mistaken belief that as an S corporation shareholder they are treated like a partner in a partnership, are surprised to learn that third-party entity-level indebtedness will not provide them with tax basis against which their share of the corporation's loss may be deducted.

Not surprisingly, taxpayers have sought to deduct their share of S corporation losses currently by taking the position that a third-party debt incurred by their corporation is, in substance, an investment by the shareholder.[16] The Internal Revenue Service has been unwilling to treat a third-party loan to an S corporation as an investment by the shareholders and has disallowed losses claimed by shareholders with insufficient tax basis in their corporations from direct capital contributions or shareholder loans.

DISCUSSION

Third-Party Debt Generally

The statutory provision dealing with the pass-through of an S corporation's losses to its shareholders is relatively straight-forward.[17] Section 1366(d)(1) allows a shareholder of an S corporation to deduct currently his distributive share of S corporation

[14] *Id.* There is no counterpart to I.R.C. § 752 in Subchapter S.

[15] Disallowed losses from an S corporation are carried forward until sufficient basis exists against which the loss can be taken. I.R.C. § 1366(d)(2) (1988).

[16] *See, e.g.*, Blum v. Commissioner, 59 T.C. 436 (1972); Perry v. Commissioner, 54 T.C. 1293 (1970); Raynor v. Commissioner, 50 T.C. 762 (1968).

[17] The relevant Code section provides:

> (d) SPECIAL RULES FOR LOSSES AND DEDUCTIONS.
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> (1) Cannot exceed shareholder's basis in stock and debt. The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of:
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> (A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraph (1) of section 1367(a) for the taxable year), and
>
> (B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).
>
> (2) Indefinite carryover of disallowed losses and deductions. Any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

I.R.C. § 1336(d) (1988).

losses to the extent of the shareholder's adjusted basis in his stock and indebtedness of the S corporation to the shareholder.[18]

Faced with the prospect of disallowed S corporation losses due to insufficient basis under §1366(d)(1), shareholders have sought to obtain basis for purposes of currently deducting their share of S corporation loss by arguing that a third-party loan to their corporation should be treated as a shareholder loan under §1366(d)(1)(B).[19] Alternatively, shareholders have argued that a third-party loan should be treated for tax purposes as a loan to the shareholder followed by a capital contribution by the shareholder, giving rise to basis under §1366(d)(1)(A).[20] A shareholder arguing for the application of §1366(d)(1) to a third party loan usually has co-signed the note to the third-party lender and guaranteed the loan. In most of the cases dealing with the application of §1366(d)(1) to third-party loans the lender relied on the financial strength of the shareholder in extending credit to the S corporation and obtained collateral from the shareholder to strengthen the loan.

The courts have been unwilling to treat third-party loans as shareholder loans under §1366(d)(1)(B).[21] In *Raynor v. Commissioner*, the Tax Court held that a taxpayer who guaranteed payment of a third-party loan to his S corporation could not treat the loan as a shareholder loan. Although the corporation's books reflected the money received from the third party lender as an indebtedness to the shareholder, the court reasoned that, "No form of indirect borrowing, be it guaranty, surety, accommodation, co-making or otherwise, gives rise to indebtedness from the corporation to the shareholder until and unless the shareholders pay part or all of the obligation. Prior to that crucial act, 'liability' may exist, but not debt to the shareholders."[22]

Since *Raynor*, shareholders have been unsuccessful in their attempts to obtain basis from third-party debt by arguing that what was in form a third-party loan was, in substance, a loan to the shareholder followed by a loan to their corporation.[23] However, the outcome is clouded when the shareholder argues that the third party loan is, in substance, a loan by the third party to the shareholder followed by a capital contribution (rather than a loan) by the shareholder to his S corporation. Although some authority exists for treating a third-party loan to an S corporation as an indirect capital contribution by the

[18] Internal Revenue Code § 1367 provides rules regarding the determination of a shareholder's adjusted basis in his stock and any loans to the corporation. *See* I.R.C. § 1367 (1988). Recently issued regulations provide guidance relating to the adjustments required by §1367, but do not address whether entity-level indebtedness affects a shareholder's basis in stock or shareholder loans. *See* Prop. Treas. Reg. §§ 1.1367-1 *and* 1.1367-2 (1992).

[19] *Raynor*, 50 T.C. at 770. The taxpayer argues that the transaction should be viewed as a loan from the third party to the shareholder/taxpayer, followed by a shareholder loan to his corporation. *Id.*

[20] *Blum*, 59 T.C. at 438.

[21] *Raynor*, 50 T.C. at 762; *Blum*, 59 T.C. at 436.

[22] *Raynor*, 50 T.C. at 770, 771.

[23] No reported case has allowed a taxpayer to deduct losses against a third-party loan under I.R.C. § 1366(d)(1)(B).

shareholder, the weight of authority (at least when one counts the number of cases deciding the issue) is against the shareholder attempting to apply §1366(d)(1)(A) to a third-party loan.[24]

Application of Debt-Equity Principles

The use of debt-equity principles to characterize a transfer of money to a corporation has had statutory support since 1970.[25] Section 385(b) lists five factors to be considered in determining whether a transfer of money to a corporation should be treated as a transaction creating a debtor-creditor relationship or a corporation-shareholder relationship.[26] Prior to the enactment of §385, case law had established a set of factors used to determine whether a transfer of funds to a corporation should be treated as debt or equity.[27] These factors are used as guidelines rather than requirements in determining the tax treatment accorded a given transaction involving the debt-equity issue.[28]

1. Loans to a C Corporation

The debt-equity issue has been raised in the context of a third-party loan to a C corporation. In *Plantation Patterns, Inc. v. United States*,[29] the shareholder of a newly formed corporation guaranteed loans made to the corporation to finance the purchase of assets to be used in the business of manufacturing wrought iron furniture.[30] The corporation was thinly capitalized and the guaranteed loans were subordinated to the other debts of the corporation.[31]

The court used debt-equity principles to determine that the guaranteed loan transaction was, in substance, a loan to the shareholder followed by a capital contribution by the shareholder in an amount equal to the amount of the loan.[32] Consequently, payments

[24] Selfe v. United States, 778 F.2d 769 (11th Cir. 1985), and Blum v. Commissioner, 59 T.C. 436 (1972), state a willingness, in appropriate circumstances, to consider a third-party loan as an indirect capital contribution by a shareholder. *But see* Harris v. United States, 902 F.2d 439 (5th Cir. 1990); Leavitt v. United States, 875 F.2d 420 (4th Cir. 1989); Brown v. Commissioner, 706 F.2d 755 (6th Cir. 1983), (where the shareholders were unsuccessful in attempts to convince the court that third-party loans should be treated as indirect capital contributions).

[25] *See* I.R.C. § 385 (1988 & Supp. III 1991) (enacted by the Tax Reform Act of 1969, Pub. L. No. 91-172, §415(a)).

[26] *Id.* The five factors are:

> (1) . . . whether there is a written, unconditional promise to pay a sum certain on demand or on a specified date, and to pay interest; (2) . . . whether the transaction purporting to be a loan creates a subordinated or preferred status with respect to the transferred funds; (3) . . . the debt/equity ratio of the corporation; (4) . . . whether the purported debt is convertible into stock; (5) . . . the relationship between the holdings of stock in the corporation and the holdings of debt.

Id.

[27] *See* Montclair, Inc. v. Commissioner, 318 F.2d 38 (5th Cir. 1963).

[28] Tyler v. Tomlinson, 414 F.2d 844 (5th Cir. 1969).

[29] 462 F.2d 712 (5th Cir. 1972), *cert. denied*, 409 U.S. 1076 (1972).

[30] *Id.* at 713.

[31] *Id.*

[32] *Id.* at 718.

made by the corporation to the third-party lender were taxed to the shareholder as dividend distributions.[33] In finding the loan transaction to be a deemed capital contribution, the court stated:

> Certainly we recognize that this transaction was initially cast to have all of the outward appearances of a debt transaction, complete with instruments styled "debentures" which had fixed maturity dates. But these surface considerations do not end our examination. Closer scrutiny establishes that the other factors which would give the transaction the aura of debt are noticeable by their absence.[34]

The court found the following factors to be determinative in recasting the transaction as a capital contribution: 1) The money was spent for capital assets; 2) Because of the thin capitalization of the corporation the third-party lender looked to the guarantee as the real source of repayment; 3) There was an identity of interest between the shareholder and the guarantor.[35]

2. Loans to an S Corporation

The debt-equity question normally arises in the context of a direct transfer of money by a shareholder to his corporation. The question in this factual setting is whether the transfer by the shareholder should be treated as a shareholder loan or a capital contribution. In the case of a corporation for which an S election is not in effect, the resolution of the debt-equity issue has significant tax consequences: subsequent payments by the corporation to the shareholder are treated as either the repayment of debt (non-taxable to the shareholder) or as a distribution with respect to the shareholder's stock (likely taxable as a dividend to the shareholder). The shareholder of an S corporation who makes a direct transfer of money to his corporation is not as concerned about the resolution of the debt-equity issue since corporate earnings are generally distributed tax-free to an S shareholder and since corporate operating losses are deductible by the shareholder against both his stock basis and his basis in shareholder loans.

An S corporation shareholder's interest in the debt-equity issue is heightened considerably when the transaction involves a third-party loan to the corporation. If the debt-equity issue is resolved in favor of debt, there is a third-party loan rather than a shareholder loan.[36] If the debt-equity issue is resolved in favor of equity, there is a deemed

[33] *Id.* at 722.

[34] *Id.*

[35] *Id.*

[36] *See* Blum v. Commissioner, 59 T.C. 436 (1972).

capital contribution by the shareholder.[37] In the context of a third-party loan to an S corporation, the resolution of the debt-equity issue may be crucial to a shareholder seeking a current tax deduction for corporate operating losses. If an S shareholder were allowed to treat a third-party loan as a capital contribution, the loan transaction might provide the necessary stock basis against which his distributive share of the corporation's operating loss could be deducted.

The first case to deal squarely with the application of § 1366(d)(1)(A) to a third-party entity-level loan was *Blum v. Commissioner*.[38] In *Blum*, the taxpayer, the sole shareholder of an S corporation that raised and raced horses, had guaranteed bank loans made to the corporation.[39] The loans were made at a time when the corporation was insolvent and thinly capitalized.[40] The taxpayer was required to pledge property other than his S corporation stock as collateral for the loan made by the bank.[41] The Service denied the deduction claimed by the taxpayer for the corporation's operating loss that exceeded the taxpayer's original capital contribution.[42] The taxpayer argued that he had sufficient basis against which the losses could be claimed since the third party loans guaranteed by him were, in substance, either indebtedness of the corporation to him or loans to him followed by capital contributions to the corporation.[43]

The Tax Court disposed of the taxpayer's first argument, that the bank loan was, in substance, a shareholder loan, citing *Raynor*.[44] The court held that in the absence of a showing that the debt ran directly to the taxpayer, the debt was not an indebtedness of the corporation to the stockholder under 1366(d)(1)(B).[45]

The Tax Court then addressed the taxpayer's alternative argument, that the loan was, in substance, a loan to him followed by a capital contribution to the corporation under § 1366(d)(1)(A).[46] The Tax Court acknowledged the efficacy of such an argument in the context of a third-party loan to an S corporation:

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[37] *See* Selfe v. United States, 778 F.2d 769 (11th Cir. 1985). *Selfe* did not actually resolve the issue in favor of the taxpayer. However, in remanding the case the Court stated that a resolution of the debt-equity issue in favor of equity would provide basis to the shareholder under I.R.C. § 1366(d)(1)(A). *Id.* at 774.

[38] *Blum*, 59 T.C. at 436. Actually, the case dealt with the application of I.R.C. § 1374(c)(2)(A), the statutory predecessor to § 1366(d)(1)(A). *See* § 1374, prior to amendment by the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (1982).

[39] *Blum*, 59 T.C. at 437.

[40] *Id.*

[41] *Id.*

[42] *Id.* at 438.

[43] *Id.*

[44] *Id.*

[45] *Blum*, 59 T.C. at 438.

[46] *Id.*

> Petitioner has not cited and we have not found any cases in which the debt-equity determination was resorted to for purposes of increasing a shareholder's loss basis in a subchapter S corporation. However, regardless of the context in which a debt-equity determination arises, we can see no distinction in principle between the case before us and the numerous cases in the area which serve as judicial guideposts.[47]

However, the Tax Court determined the taxpayer had simply not shown that application of traditional debt-equity principles to the facts presented compelled the court to hold the bank loan to be, in substance, a capital contribution providing basis to the taxpayer for purposes of §1366(d)(1)(A):

> As we stated in Santa Anita consolidated, Inc. supra at 550, "Whether such debt [guaranteed debt] is to be treated as an indirect capital contribution must be resolved by an investigation of the facts in light of traditional debt-equity principles." In the present and fully stipulated case, after applying many of those traditional principles, we find that petitioner simply has not carried his burden of proof and has not convinced this court that the guaranteed loans should be properly characterized as equity investments.[48]

The court found it significant that no evidence was offered to show the bank expected repayment of its loan from the shareholder.[49] Based on the evidence offered, application of debt-equity principles did not serve to increase the basis of the taxpayer's stock.

The decision in *Blum v. Commissioner* is similarly significant in that the Tax Court, for the first time, recognized that, in the context of an S corporation and its shareholder, the use of debt-equity principles is appropriate to recharacterize a third-party loan to a corporation as a contribution by the shareholder. The problem for the taxpayer in *Blum* was that he failed to provide evidence sufficient to recharacterize the loan as an indirect capital contribution.

3. Economic Outlay

In the case of *Brown v. United States*,[50] the Sixth Circuit affirmed the Tax Court's holding that shareholders could not deduct losses against a third-party loan guaranteed by the shareholders.[51] The shareholders had asserted that debt-equity principles should

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[47] *Id.* at 439.

[48] *Id.* at 439-40.

[49] *Id.* at 440.

[50] 706 F.2d 755 (6th Cir. 1983).

[51] *Id.* at 757.

serve to recharacterize the third-party loan as an indirect capital contribution and cited *Blum* as support for their position.[52]

The Tax Court in *Brown*, cited *Raynor* for the proposition that an economic outlay is required before an S shareholder can receive basis under §1366(d)(1)(B) and that a guarantee of the debt of an undercapitalized corporation does not amount to an economic outlay.[53] With regard to the debt-equity argument, the Tax Court simply stated that *Blum* was not inconsistent with the rule stated in *Raynor*.[54] The Tax Court concluded that, based on the facts, the substance of the transaction matched its form and recharacterizing the loan as an indirect capital contribution would be inappropriate.[55]

In affirming the decision of the Tax Court, the Sixth Circuit accepted the Tax Court's finding that the substance of the loan transaction matched the form and therefore no capital contribution by the shareholders occurred.[56] However, after citing several cases that address taxpayers' claims that third-party loans should be treated as shareholder loans, the Sixth Circuit concluded: "In any event, we hold that guaranteeing shareholders must make actual disbursements on the corporate indebtedness before they can augment their bases for the purpose of deducting net operating losses under [§1366(d)(1)]."[57]

In light of the fact that the appellate court in *Brown* agreed with the Tax Court's finding that the substance of the loan transaction matched its form, the holding quoted above could be viewed as merely reiterating the well established rule that guaranteeing a corporate debt will not be treated as a shareholder loan under §1366(d)(1)(B). However, the court's holding refers to §1366(d)(1) - not §1366(d)(1)(B) - and therefore one could conclude the Sixth Circuit requires actual disbursements by a shareholder before treating the loan as a capital contribution under traditional debt-equity analysis. Such an expansion of the Tax Court's holding would seem unwarranted in light of the factual determination that the substance of the loan transaction met its form. Nevertheless, in its rebuke of the taxpayer's reliance on *Blum*, the Sixth Circuit stated that *Blum* does not depart from the economic outlay requirement.[58]

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[52] *Id.* at 756.

[53] *Id.*

[54] Brown v. Commissioner, 50 T.C.M. (P-H) 1981-2359, *aff'd*, 706 F.2d 755 (6th Cir. 1983). *Blum* is not inconsistent with *Raynor*. However, *Blum* does say more about debt-equity principles in a case involving an S Corporation than does *Raynor*; *Raynor* never addresses the issue.

[55] *See id.* at 2360.

[56] *Brown*, 706 F.2d at 756.

[57] *Id.* at 757.

[58] *Id.* at 756. In discussing *Blum*, the Sixth Circuit states, "... in deciding that *Blum* was not entitled to a stepped-up basis because of his guaranty, the Tax Court emphasized that the bank expected repayment of its loan from the corporation and not the petitioner." *Id.* (citing *Blum* 59 T.C. at 440). The implication of this statement seems to be that the Sixth Circuit feels an economic outlay is made by a shareholder when the bank expects repayment from the shareholder.

S Shareholder Guarantees of Third-Party Loans

1. Positive Responses

The case most often cited by S corporation shareholders attempting to convert a third-party loan into a capital contribution under debt-equity principles is *Selfe v. United States*.[59] In *Selfe*, the taxpayer, intending to operate a retail clothing business, arranged financing with a bank whereby the bank agreed to loan her $120,000 (a line of credit).[60] To secure the loan the taxpayer pledged stock in another corporation which she owned.[61] After arranging the loan, the business was incorporated and an election to be taxed as a S corporation was made.[62] At the bank's request, the line of credit was converted to a corporate loan.[63] According to testimony from the loan officer, the bank wanted the assurance of having the corporation primarily liable on the loan.[64]

The taxpayer claimed the deduction for her distributive share of the corporation's operating loss that exceeded her original capital contribution to the corporation.[65] However, the Service denied her deduction. When the district court granted summary judgment in favor of the Service's position, the taxpayer appealed.[66]

The taxpayer argued the loan should be treated as though it was made to her and that she transferred the loan proceeds to her corporation as a capital contribution.[67] In essence, the taxpayer urged the Court to apply traditional debt-equity principles in determining whether the loan transaction was, in substance, an indirect capital contribution.[68] The taxpayer pointed to the testimony of the loan officer that the bank loan was secured by the taxpayer's property and that the bank was looking primarily to the taxpayer and her pledged stock for repayment of the loan.[69]

The Eleventh Circuit Court in *Selfe* remanded the case to the district court.[70] In so doing, the Court concluded, ". . . under the principles of *Plantation Patterns*, a shareholder who has guaranteed a loan to a Subchapter S Corporation may increase her basis

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59 778 F.2d 769 (11th Cir. 1985).

60 *Id.* at 770.

61 *Id.*

62 *Id.*

63 *Id.*

64 *Id.* at 771.

65 *Id.*

66 *Id.* at 770.

67 *Id.* at 771.

68 *Id.* The taxpayer cited *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972), as authority for applying debt-equity principles to a case involving third-party loans guaranteed by the shareholder when the facts and circumstance indicate that the lender looks primarily to the shareholder for repayment. *Selfe*, 778 F.2d at 771.

69 *Selfe*, 778 F.2d at 771.

70 *Id.* at 775.

where the facts demonstrate that, in substance, the shareholder has borrowed funds and subsequently advanced them to her corporation."[71] The Court was not persuaded by the Service's argument that characterizing the transaction under debt-equity principles was inappropriate in the case of an S corporation.[72]

According to the Eleventh Circuit, shareholders who guarantee third-party loans to their corporation are generally unsuccessful in recharacterizing the guarantee as a capital contribution because the taxpayer cannot show that the substance of the transaction differs from its form.[73] However, when the lender looks primarily to the shareholder as the source for repayment of the loan, an analysis of the substance of the transaction under debt-equity principles must be engaged in to determine if an equity investment was made by the shareholder.[74]

2. Negative Responses

The cases decided since the *Selfe* decision have not rushed to embrace the notion that guaranteed debt can be characterized as a capital contribution for purposes of §1366(d)(1)(A). In *Bader v. Commissioner*[75] the taxpayers formed a corporation for the practice of radiology.[76] They contributed, in the aggregate, $2,000 in exchange for their stock.[77] The corporation made a proper election to be treated as an S corporation, and, each shareholder borrowed, individually, $75,000 from a bank.[78] The shareholders immediately loaned the borrowed funds to their newly formed corporation.[79] Approximately seven months after the original bank loans, the taxpayers' loan agreements were consolidated into one bank loan.[80] The corporation was listed as the primary obligor in the new loan agreement; the taxpayers were listed as guarantors.[81] The corporation incurred a net operating loss for its initial tax year and the taxpayers treated their proportionate shares of the bank loan as shareholder loans, creating bases against which their distributive shares of the net operating loss were deducted.[82]

The IRS challenged the deduction, claiming that the bank loan was not shareholder debt under §1366(d)(1)(B) and denied the taxpayers a deduction for the S corporation's

[71] *Id.* at 773.
[72] *Id.* at 774.
[73] *Id.*
[74] *Id.* at 775.
[75] 56 T.C.M. (P-H) 1987-137.
[76] *Id.*
[77] *Id.*
[78] *Id.* at 138.
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.*

net operating loss.[83] The taxpayers claimed the restructured loan should be treated as a loan from them to the corporation.[84] The taxpayers argued that they were, in substance, the primary obligors on the bank loan and that the rationale expressed in *Selfe* should apply to their case.[85]

The Tax Court held the bank loan was not, in substance, a shareholder loan and disallowed the losses claimed by the taxpayers on their individual tax returns.[86] The court found no evidence in the documentation of the restructured debt instruments to indicate the taxpayers were the primary obligors or that the bank considered the taxpayers the primary obligors.[87] The court found the debt to run between the bank and the corporation.[88] With regard to the application of the *Selfe* rationale, the court stated:

> We have reservations with regard to the application of the reasoning in *Selfe v. United States* absent an argument being made that the debt in question should be considered a contribution to the capital of the corporation rather than debt of the corporation. The parties have not made this argument. Further, petitioners have not established that CNB looked primarily to them for satisfaction of the debt.[89]

If the taxpayers had sought to characterize the transaction as an indirect capital contribution, the court in *Bader* might have been persuaded to adopt the rationale in *Selfe*, because of the fact that the original loans were direct shareholder loans clearly creating basis under §1366(d)(1)(B) prior to the restructuring. However, the court may well have held in favor of the government absent a stronger case by the taxpayers that the bank looked to them for repayment of the loan.[90]

In *Gurda v. Commissioner*,[91] shareholders attempted to increase basis in their S corporation by loans obtained by the S corporation from a related corporation which had borrowed the funds from an unrelated financial institution.[92] The Tax Court held that the transaction did not give rise to additional basis for the shareholders and that *Selfe* did not help the taxpayer:

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83 *Id.* at 139.

84 *Id.*

85 *Id.*

86 *Id.* at 140.

87 *Id.*

88 *Id.* at 139.

89 *Id.* at 140.

90 *Bader* was decided prior to Estate of Leavitt v. Commissioner, 90 T.C. 206 (1988) *aff'd*, 875 F.2d 420 (4th Cir. 1989), and the Tax Court's opinion in *Leavitt* certainly renders the language in *Bader* quoted above much less significant than it might otherwise be. *See* discussion *infra* p. 13.

91 56 T.C.M.(P-H) 1987-2023.

92 *Id.* at 2023-24.

> *Selfe v. United States*, *supra*, does not apply to this case. The Selfe holding is premised on proof that the lender looks primarily to the guarantor/shareholder for repayment of the corporation's debt. In this case. HNB, the third-party lender, looks primarily to Wallkill, the borrower, for repayment of the loan. Therefore, the guarantees given by the Gurdas and the Slutskys do not give rise to liability for repayment of the loan sufficient to establish that Wallkill's subsequent loan of the funds to Speedways represents an equity investment which would increase their basis in their stock in that corporation.[93]

The Tax Court did not take this opportunity to repudiate the rationale of *Selfe*, but chose to distinguish *Gurda* on the facts. For this reason, *Gurda* could be seen as suggesting the *Selfe* rationale has merit, but that the rationale simply did not apply to the facts presented. However, in light of subsequent Tax Court cases, it seems more likely that the Tax Court may have been simply deciding the case before it.[94]

3. Estate of Leavitt v. United States

The case that appears to be cited most often for the proposition that shareholder guarantees of corporate loans will not be treated as capital contributions is *Estate of Leavitt v. United States*.[95] In *Leavitt*, the taxpayers sought to deduct their distributive shares of operating losses incurred by their S corporation.[96] The deductions were taken against their pro rata shares of a bank loan to the corporation in the total amount of $300,000.[97] The shareholders guaranteed the bank loan.[98] At the time of the bank loan, the corporation was insolvent, its liabilities exceeded the value of its assets.[99] During its first tax year (a short year of seven months) the corporation generated a loss of $265,000 and was unable to generate the cash flow necessary to operate.[100] The corporation had virtually no assets to use as collateral.[101] The corporation's financial statements classified the $300,000 bank loan as a shareholder loan although payments on the loan were made by the corporation and were not treated as distributions to the shareholders.[102]

The shareholders treated the bank loan as a shareholder loan under §1366(d)(1)(B) and deducted their distributive share of the loss.[103] The Service denied the losses on the

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[93] *Id.* at 2027.

[94] *See* Estate of Leavitt, 90 T.C. at 206; *see also* Nigh v. Commissioner, 59 T.C.M.(P-H) 1990-1657.

[95] Estate of Leavitt v. Commissioner, 875 F.2d 420 (4th Cir. 1989).

[96] *Id.* at 421.

[97] *Id.*

[98] *Id.*

[99] *Id.*

[100] *Id.* at 421 n. 4.

[101] *Id.* at 421-22.

[102] *Id.* at 422.

[103] *Id.*

grounds that the bank loan was not a shareholder loan under §1366(d)(1)(B).[104] The Tax Court decided the case in the favor of the Service, holding that shareholder guarantees of the bank loan did not convert the third-party loan into a shareholder loan under §1366(d)(1)(B) or an indirect capital contribution under §1366(d)(1)(A).[105] In deciding that the taxpayer was not allowed to recharacterize the loan as a capital contribution the Tax Court held that in order for a shareholder to increase basis under §1366(d), there must be an economic outlay.[106] After analyzing the form of the transaction the Tax Court found no economic outlay, concluding that since the taxpayer's guarantees did not require any actual payment during the years in issue, there could be no increase in basis.[107]

The Tax Court declined the invitation of the taxpayer to apply traditional debt-equity principles to determine whether the guaranteed debt was in substance a capital contribution by the shareholders.[108] The Tax Court specifically rejected the holding in *Selfe* that a shareholder guaranty of a loan to his S corporation may be treated as a contribution to capital by the shareholder when traditional debt-equity analysis indicates the shareholder should be treated as though he borrowed the money from the third-party lender and contributed the loan proceeds to the S corporation.[109] The Tax Court held that shareholder guarantees may not be treated as an investment in an S corporation absent an economic outlay by its shareholders and that traditional debt-equity analysis is inappropriate in the case of an S corporation.[110]

Citing language from the Senate Finance Committee's report, the Tax Court concluded that the drafters of I.R.C. §1374(c)(2) (the statutory predecessor to I.R.C. §1366(d)(1)) intended to require an actual economic outlay:[111] "Congress has promulgated a set of rules designed to limit the amount of deductions allowable to a shareholder of a Subchapter S corporation to the amount he has actually invested in the corporation

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[104] *Id.*

[105] *Leavitt*, 90 T.C. at 206. The Tax Court cited Raynor v. Commissioner, 50 T.C. 762 (1968), for the proposition that no form of indirect borrowing is treated as a shareholder loan unless the shareholder actually pays part or all of the obligation. *Estate of Leavitt*, 90 T.C. at 211.

[106] *Id.* at 212. The Tax Court cited Brown v. United States, 706 F.2d 755 (6th Cir. 1983), for the proposition that an economic outlay is required for purposes of § 1366(d)(1)(A) and (d)(1)(B). *Leavitt*, 90 T.C. at 212.

[107] *Id.* at 213.

[108] *Id.* at 215.

[109] *Id.* at 216.

[110] *Id.*

[111] *Id.* at 217. The language cited from the Senate Finance Committee's report is as follows:

> The amount of the net operating loss apportioned to any shareholder pursuant to the above rule is limited under section 1374(c)(2) to the adjusted basis of the shareholder's *investment* in the corporation; that is, to the adjusted basis of the stock in the corporation owned by the shareholder and the adjusted basis of any indebtedness of the corporation to the shareholder. [S. REP. NO. 1983, 85th Cong., 2d Sess. (1958), 1958-3 C.B. 1141. [Emphases added.].

Id.

and the amounts of income from the corporation included in the shareholder's gross income."[112]

The taxpayers appealed the decision of the Tax Court to the Fourth Circuit, which affirmed the Tax Court's decision.[113] The Fourth Circuit adopted the holding of the Tax Court that shareholders' guarantees of third-party loans to their S corporation do not create basis absent an economic outlay by the shareholders.[114]

Under the analysis provided by the Fourth Circuit, the use of debt-equity principles to characterize a bank loan as a shareholder loan is inappropriate until it has been determined that an economic outlay has been made by the shareholder:

> We believe that the Tax Court correctly refused to apply debt-equity principles here, a methodology which is only relevant, if at all, to resolution of the second inquiry - what is the nature of the economic outlay. Of course, the second inquiry cannot be reached unless the first question concerning whether an economic outlay exists is answered affirmatively. Here it is not. The appellants, in effect, attempt to collapse a two-step analysis into a one-step inquiry which would eliminate the initial determination of economic outlay by first concluding that the proceeds were a capital contribution (equity). Obviously, a capital contribution is an economic outlay so the basis in the stock would be adjusted according. But such an approach simply ignores the factual determination by the Tax Court that the Bank lent the $300,000 to the corporation and not to the Shareholders-Guarantors.[115]

Under this two-step approach, the court never reaches the debt-equity analysis, since it refuses to overturn the Tax Court's finding that the shareholders did not make an economic outlay. The taxpayers cited *Blum* and *Selfe* to support their position that the application of debt-equity principles is appropriate in the context of a third-party loan to an S corporation and argued that its application would result in an economic outlay in the form of a deemed capital contribution.

The Fourth Circuit found *Blum* to be no impediment to its two-step approach in determining whether a shareholder has made an investment in his S corporation. The court found that *Blum* did not apply debt-equity principles to determine whether a

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[112] *Id.* at 216.

[113] Estate of Leavitt v. Commissioner, 875 F.2d 420 (4th Cir. 1989).

[114] *Id.* at 422.

[115] *Id.* at 425.

shareholder guarantee of a loan from a bank to his corporation was an indirect capital contribution.[116] According to the Fourth Circuit, the taxpayer simply misread *Blum*.[117]

With regard to *Selfe*, the Fourth Circuit found that language in the Eleventh Circuit's opinion implies a two-step analysis where debt-equity analysis is engaged in only after an economic outlay is established.[118] However, the Fourth Circuit was concerned with the following final statement of the *Selfe* opinion: "In short, we remand for the district court to apply *Plantation Patterns* and determine if the bank loan to Jane Simon, Inc., was in reality a loan to the taxpayer."[119] The Fourth Circuit disagreed with the suggestion in *Selfe* that debt-equity principles should be applied to determine whether the shareholder should be treated as the borrower when a third party loans money directly to the shareholder's S corporation: "It is because of the *Selfe* court's suggestion that debt-equity principles must be applied to resolve the question of whether the bank actually lent the money to the taxpayer/shareholder or the corporation, that we must part company with the Eleventh Circuit for the reasons stated above."[120]

4. Leavitt's Progeny Continues Requirement of Economic Outlay

Since the *Leavitt* decision, the Tax Court has entrenched its position that shareholder guarantees do not provide a shareholder the opportunity to deduct his distributive share of S corporation losses under debt-equity's indirect capital contribution rationale. In *Suisman v. Commissioner*,[121] a case decided after *Leavitt*, the Tax Court again declined a taxpayer's suggestion to follow the rationale in *Selfe*.[122] The taxpayers in *Suisman* formed an S corporation to operate a boat charter business.[123] The corporation borrowed funds from a bank and the shareholders guaranteed the loan.[124] Two years after the

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[116] *Id.*

[117] *Id.*

[118] *Id.* at 426, 427. The Fourth Circuit states:

> The *Selfe* court found that there was evidence that the bank primarily looked to the taxpayer and not the corporation for repayment of the loan. Therefore, it remanded for a determination of whether or not the bank primarily looked to Jane Selfe [taxpayer] for repayment [the first inquiry] and for the court to apply the factors set out in *In re Lane* and I.R.C. section 385 to determine if the taxpayer's guarantee amounted to either an equity investment in or shareholder loan to Jane Simon, Inc. [the second inquiry] *Id.* at 775. The implications are that there is still a two-step analysis and that the debt-equity principles apply only to the determination of the characterization of the economic outlay, once one is found.

Id.

[119] Selfe v. United States, 778 F.2d 769, 775 (11th Cir. 1985).

[120] *Estate of Leavitt*, 875 F.2d at 427.

[121] 58 T.C.M.(P-H) 1989-3174.

[122] *See id.* at 3175-76.

[123] *Id.* at 3174.

[124] *Id.*

original loan, the corporation sold its boat and made a large payment to the bank.[125] The corporation executed a note to the bank for the remaining loan balance, and the taxpayers guaranteed payment on the new note.[126]

The taxpayer argued that his basis in the corporation should be increased by the guaranteed loan, citing *Selfe*.[127] The Tax Court rejected the taxpayer's argument and accepted the economic outlay argument set forth in *Leavitt*.[128] The Tax Court found no economic outlay since the loan payments were made by the corporation and were not treated as constructive dividends by the corporation.[129] In light of its reliance on *Leavitt*, *Suisman* could be viewed as a restatement of the Tax Court's intractability on the *Selfe* issue. However, in its determination that no economic outlay was made, *Suisman* appears to put great emphasis on who paid off the loan. One wonders if the court's decision would have been different had the corporation recorded the loan repayments as constructive dividends.

In *Harris v. United States*,[130] the taxpayers had contracted to purchase a pornographic theater that they intended to convert into a wedding hall.[131] In an effort to avoid any adverse publicity that might arise due to their purchase of a pornographic theater, to limit their personal liability, and to enhance their chances of obtaining financing through industrial revenue bonds, the taxpayers formed a corporation to acquire the property.[132] The corporation elected to be taxed an S corporation.[133] The taxpayers had made tentative arrangements to finance the project in their individual capacities, but the final loan agreement was between the newly formed corporation and the bank.[134] The shareholders each executed personal continuing guarantees of the corporation's indebtedness.[135] The bank was given a mortgage on the theater.[136] In addition, the shareholders secured the bank loan with certificates of deposit.[137] An officer of the bank testified that the loan was intended to be made to the corporation, but that the bank looked primarily to the taxpayers, rather than the corporation, for repayment of the loan.[138]

125 *Id.* at 3175.

126 *Id.*

127 *Id.*

128 *Id.*

129 *Id.* at 3176.

130 902 F.2d 439 (5th Cir. 1990).

131 *Id.* at 440.

132 *Id.*

133 *Id.*

134 *Id.*

135 *Id.*

136 *Id.*

137 *Id.*

138 *Id.*

The taxpayers deducted losses in the corporation in excess of their actual capital contributions. They took the position that the bank loan was, in substance, an indirect capital contribution against which their distribution share of S corporation loss could be deducted.[139] The Internal Revenue Service disagreed.[140]

The Fifth Circuit affirmed the decision of the district court, granting summary judgment in favor of the government. The Fifth Circuit cited favorably the language in *Leavitt* that requires a finding of actual economic outlay on the part of a shareholder prior to any debt-equity analysis.[141] According to the Fifth Circuit, *Selfe* was not applicable to the case before it since, ". . . the transaction as structured did not lack adequate substance or reality and . . . an economic outlay justifying the basis claimed by taxpayers never occurred."[142]

The court then reviewed the evidence in support of its order affirming summary judgement.[143] The parties intended the transaction to be a loan from the bank to the corporation.[144] The notes were executed by the corporation.[145] The loan proceeds were used by the corporation to purchase the theater; the corporation took title to the property.[146] Interest due notices were sent to the corporation and payments on the loan were made by the corporation.[147] The corporation's books and records reflected the loan as a debt owed to the bank (rather than as a capital contribution) and payments were treated as interest payments by the corporation (rather than distributions to the taxpayers).[148]

The Fifth Circuit did not discuss the applicability of the *Selfe* rationale to the case before it in connection with evidence that the bank looked to the shareholders of the S corporation for repayment of the loan. According to *Selfe*, such a finding necessitates an investigation into the substance of the transaction to determine whether the shareholder guarantee amounts to a capital contribution by the shareholder. The Fifth Circuit in *Harris* determined the substance of the transaction by simply analyzing the docu-

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[139] *Id.* at 441.

[140] *Id.*

[141] *Id.* at 442. The Fifth Circuit determined that the pledging of security by a shareholder is not an economic outlay justifying an increase in basis. *Harris*, 902 F.2d at 445. *Leavitt* did not include a claim by the taxpayer that pledging collateral is an economic outlay, and the Fourth Circuit left open the question of ". . . whether a guarantee can be an economic outlay when accompanied by pledged collateral." Estate of Leavitt v. United States, 875 F.2d 420, 426-27, n.17 (4th Cir. 1989).

[142] *Harris*, 902 F.2d at 443.

[143] *Id.* at 443.

[144] *Id.*

[145] *Id.* at 443-44.

[146] *Id.* at 444.

[147] *Id.*

[148] *Id.*

ments prepared in support of the bank loan.[149] The order affirming summary judgement cannot be reconciled with *Selfe* and the court in *Harris* made no real attempt to do so.

In *Nigh v. Commissioner*,[150] the Tax Court held that shareholders of an S corporation were not entitled to treat third-party loans made to their S corporation as capital contributions.[151] In *Nigh*, the lenders (two different banks) obtained notes from the corporation and its shareholders as co-makers.[152] This was the standard policy of the banks on all loans to closely held corporations.[153] The banks would not have made the loans to the corporation without the shareholders' signatures.[154]

The taxpayers argued that as co-makers of the notes, they had, in substance, borrowed the funds from the banks and contributed the loan proceeds to the capital of the corporation.[155] The Tax Court rejected the taxpayers' argument, citing language from its opinion in *Leavitt* that absent an economic outlay by the shareholder, no tax basis is obtained by a shareholder in the case of third-party loans to a corporation, regardless of whether the shareholder was a co-maker or guaranteed the loan.[156]

The *Nigh* case is a reaffirmation by the Tax Court of its position expressed in *Leavitt*. *Suisman* and *Nigh* certainly suggest that taxpayers willing to litigate the debt-equity issue in the context of a third-party loan to an S corporation should either choose a different court of original jurisdiction or be willing to take their fight to the court of appeals.[157]

Two-Step Approach Required to Apply Debt-Equity Principles

1. The *Leavitt* Test

The *Leavitt* case and its progeny argue that there must be an actual economic outlay by the shareholder before traditional debt-equity principles will be applied to determine whether the nature of the transaction is a loan or a capital contribution. As stated in *Leavitt*, this is a two-step approach. An actual economic outlay must first be found before proceeding to the second step; determining whether the outlay is a loan or a capital contribution. However, it is only after the facts and circumstances surrounding the

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149 *Id.* at 443, 444.

150 59 T.C.M.(P-H) 1990-1657.

151 *Id.* at 1662.

152 *Id.* at 1658.

153 *Id.*

154 *Id.*

155 *Id.* at 1662.

156 *Id.*

157 Other Tax Court cases are equally cool to the *Selfe* rational. *See* Erwin v. Commissioner, 58 T.C.M.(P-H) 1989-379. In addition, the Fourth Circuit (*Leavitt*), Fifth Circuit (*Harris*), and Sixth Circuit (*Brown*) are not friendly forums for a taxpayer seeking acceptance of the *Selfe* rational.

transaction are analyzed that the nature of the transfer of funds by the third-party lender to the corporation can be determined. The substance, not the form, of the transaction should determine its characterization.[158] The *Leavitt* line of cases fail to engage in this analysis and instead look at the form (as opposed to the substance) of the transaction to determine that no economic outlay occurs. Under the analysis provided by *Leavitt*, no other conclusion could be reached.

In the context of a bank loan guaranteed by a shareholder, the form of the transaction precludes an actual economic outlay by the shareholder (the money is transferred from the bank to the corporation). The *Leavitt* Tax Court, in determining the nature of the transaction, states:

> The Bank of Virginia loaned the dollars to the Corporation and not to the petitioners . . . Nor were the payments on the loan reported as constructive dividends on the corporation's Federal income tax returns or on petitioner's Federal income tax returns during the years in issue. Accordingly, we find that the transaction was in fact a loan by the bank to the corporation guaranteed by the shareholders.[159]

In essence, the Tax Court in *Leavitt* looked at the form of the transaction, rather than the substance, to determine that no economic outlay occurred.

Although the Tax Court in *Leavitt* flatly refused to adopt debt-equity principles in the context of shareholder guarantees of S corporation debt, the Fourth Circuit was not ready to make such a declaration. However, in the context of shareholder guarantees of third-party loans, the two-step approach adopted by the Fourth Circuit puts the taxpayer in no better position than he faces in the Tax Court. Without rejecting the use of debt-equity principles in the context of an S corporation and its shareholders, the Fourth Circuit's first step in its two-step analysis - requirement of an actual economic outlay - serves to eliminate any consideration of debt-equity principles.

This has a negative impact on a shareholder who has guaranteed a third-party loan to his S corporation. If the court is unwilling to consider the substance (as opposed to the form) of the transaction between the bank, shareholder, and the S corporation in determining whether there has been an economic outlay (and it appears the courts in *Leavitt* line of cases are unwilling), debt-equity analysis will never be engaged in.

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[158] *See* Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1992); *In Re* Breit, 460 F. Supp. 873 (E.D. Va. 1978).

[159] Estate of Leavitt v. Commissioner, 90 T.C. 206, 214 (1988), *aff'd*, 875 F.2d 420 (4th Cir. 1989).

2. The Problem with the *Leavitt* Test

Debt-equity principles are normally used to determine whether a shareholder loaned money or contributed capital to his corporation.[160] The resolution of this issue is significant to the shareholder of a Subchapter C corporation. The repayment of the debt, normally a nontaxable event, could be treated as a taxable dividend distribution if the transaction cast in the form of a shareholder loan is recast as a capital contribution. In the case of a shareholder and his S corporation, the resolution of the debt-equity issue in the case of a direct transfer from the shareholder to his corporation is irrelevant, at least with respect to deducting entity-level operating losses, since losses can be taken against capital contributions and shareholder loans.[161] However, in cases such as *Plantation Patterns*, the issue is not whether the shareholder directly loaned money or contributed capital to his corporation, but rather, whether a loan from a third party to the corporation should be treated, for tax purposes, as a loan to the shareholder followed by a contribution of capital by the shareholder to the corporation. The substance of the transaction which takes the form of a third-party loan to the corporation is analyzed to determine whether the form of the transaction should be conclusive for tax purposes. *Blum* and *Selfe* held that the substance of a loan transaction should be analyzed in a case involving an S corporation shareholder's guarantee of a third-party loan to his corporation, just as it should in a case involving the same shareholder and the same transaction when his corporation does not have an S election in effect.

The Tax Court in *Leavitt* held that the *Plantation Patterns* line of debt-equity analysis is inappropriate in a case involving an S corporation and cites language from the Senate Finance Committee report to support its position.[162] However, the language relied on by the Tax Court says only that the S corporation shareholder's loss should be limited to his investment in the corporation. The committee report does not state that an actual economic outlay is required. Thus the legislative history simply does not support the Tax Court position.

The Fourth Circuit in *Leavitt* accepted the Tax Court's conclusion that no economic outlay was made by the taxpayer, and thereby accepted an analysis of the loan transaction's form rather than its substance.[163] In *Leavitt*, the Fourth Circuit concluded, "... the Tax

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160 Montclair, Inc. v. United States, 318 F.2d 38 (5th Cir. 1963).

161 I.R.C. § 1366(d)(1) (1988).

162 *Estate of Leavitt*, 90 T.C. at 217.

163 In analyzing the substance the transaction, the Tax Court states:

> The Bank of Virginia loaned the money to the corporation and not to petitioners. The proceeds of the loan were to be used in the operation of the corporation's business. Petitioners submitted no evidence that they were free to dispose of the proceeds of the loan as they wished. Nor were the payments on the loan reported as constructive dividends on the corporation's Federal income tax returns or on petitioners' Federal income tax returns during the years in issue. Accordingly, we find that the transaction was in fact a loan by the bank to the corporation guaranteed by the shareholders.

Estate of Leavitt, 90 T.C. at 213, 214.

Court correctly focused on the initial inquiry of whether an economic outlay existed. Finding none, the issue of whether debt-equity principles ought to apply to determine the nature of the economic outlay was not before the Tax Court."[164]

If the Fourth Circuit was not rejecting the use of debt-equity principles in a case involving an S corporation and its shareholders, then it should have remanded the case to the Tax Court due to the Tax Court's failure to adequately address the initial inquiry demanded by the Fourth Circuit, namely was there an economic outlay? The Tax Court focused on the form of the transaction only and not on the substance. The Tax Court could not have found an economic outlay by the shareholder since it refused to apply *Plantation Patterns*. The approach taken by the Tax Court fails to consider the economic outlay deemed to be made by a shareholder who, under the *Plantations Patterns* rationale, is treated for tax purposes as though he actually contributed capital to his corporation.[165] The Tax Court in *Leavitt* never looked at the substance of the loan transaction. The credit worthiness of the corporation, the lack of assets available as collateral, the insolvency of the corporation, and on whom the bank relies for repayment were not addressed in determining whether there was an economic outlay by the shareholder. The form of the transaction apparently answers the initial question.

The Fourth Circuit would restrict the use of debt-equity principles in a case involving shareholder guarantees by requiring a finding of an actual economic outlay before applying those principles. This restriction amounts to a de facto rejection of the use of debt-equity principles in the case of a shareholder guarantee of a third-party entity-level loan.

An unwillingness to apply debt-equity principles to determine whether a third-party loan is, in reality, a loan to a shareholder cannot be reconciled with I.R.C. §1371. Section 1371 provides that except to the extent inconsistent with Subchapter S, Subchapter C applies to an S corporation and its shareholders.[166] The debt-equity principles discussed in *Plantation Patterns* are reflected in Subchapter C.[167]

There is no provision in Subchapter S with which the debt-equity rules are inconsistent. The Tax Court's reliance, (and to a lesser degree, the Fourth Circuit Court's reliance) on the language found in the Senate Finance Committee's report is misplaced. The committee report states only that the currently deductible amount of the shareholder's distributive share of the S corporation's loss should be limited to his investment in the corporation.[168] The report's statement that a shareholder's ability to deduct losses from his S corporation should be limited to his "investment" in the corpo-

[164] Estate of Leavitt v. United States, 875 F.2d 420, 427 (4th Cir. 1989).

[165] *Estate of Leavitt*, 90 T.C. at 219 (Fay, J., dissenting).

[166] I.R.C. § 1371(a)(1) (1988).

[167] *See* I.R.C. § 385 (1988 & Supp. III 1991).

[168] S. REP. NO. 1983, 85th Cong., 2d Sess. (1958), 1958-3 C.B. 922, 1141.

ration is certainly not a clear prohibition against utilizing debt-equity principles. An actual economic outlay is not required by the language in the report. The language from the committee report can be more easily interpreted to mean that a shareholder can deduct his share of an S corporation loss in an amount that the normal corporate rules – including debt-equity rules – determine to be his investment in the corporation.

The untenability of the *Leavitt* rationale is evident if one considers a shareholder who has guaranteed payment on a third-party loan to his corporation. Suppose, under the debt-equity principles enunciated in *Plantation Patterns*, a loan transaction in the form of a bank loan to a corporation is recharacterized for tax purposes as a loan to the shareholder followed by a capital contribution to his corporation. While a regular C corporation, payments made by the corporation (and recorded as debt service on the corporation's books and records) would be treated as constructive dividends to the shareholder. Assume the corporation then made an election to be treated as an S corporation. Under the rationale of the *Leavitt* line of cases, the shareholder could not deduct corporate operating losses against the balance due on the third-party loan since no actual economic outlay was made by the shareholder.

It would be unfair to the shareholder to treat the third-party loan as a capital contribution for purposes of taxing him on the corporation's payments to the bank, but not for purposes of determining his investment in the corporation under §1366(d)(1). More importantly (perhaps not to the shareholder), such an interpretation of the law would violate the statutory mandate of §1371 that unless inconsistent with some provision in Subchapter S, the rules applicable to C corporations and their shareholders should apply to an S corporation and its shareholders.

Adopting the view of *Blum* and *Selfe* that application of debt-equity principles is appropriate in the context of shareholder guarantees of third-party loans to an S corporation creates no inconsistency. The loan transaction described above would be subject to the same characterization regardless of the tax status of the corporation. Moreover, this treatment would not afford the shareholder any advantage should he terminate his S election. Any payments made on the loan after the termination of the S election would be treated as distributions to the shareholder and taxed as dividends to the extent of the corporation's earnings and profits.[169] Any loan payments made in excess of earnings and profits would be treated in the same manner as if the shareholder had not terminated his S election.[170] The shareholder's stock basis would be reduced by the corporation's losses claimed by him during the period of the S election.[171] The loan payments made in excess

[169] I.R.C. § 301(c)(1) (1988).

[170] *Compare* I.R.C. § 1368(b) (1988) *with* I.R.C. § 301(c)(2), (c)(3) (1988).

[171] I.R.C. § 1367 (1988).

of the corporation's earnings and profits would be treated as gain to the extent the payments exceeded any remaining stock basis.[172]

Inconsistencies with the Position of the IRS

The Service's insistence that an S corporation shareholder make an actual economic outlay prior to obtaining tax basis in the context of shareholder guarantees of third-party loans is surprising in light of the position taken in Revenue Ruling 75-144.[173] In Revenue Ruling 75-144, the Service concluded that a shareholder who substitutes his note for the note of his S corporation obtains basis against which the corporation's operating losses may be deducted.[174]

Revenue Ruling 75-144 involved a shareholder who guaranteed payment of a loan made by a bank to the shareholder's S corporation.[175] The corporation defaulted on the loan.[176] The shareholder was called up to fulfill his obligation as guarantor.[177] The bank accepted the shareholder's own promissory note for the corporate note, which was canceled by the bank upon receipt of the shareholder's note.[178]

A guarantor who pays a debt of the primary obligor is subrogated to the rights of the lender.[179] When the bank canceled the corporation's note and accepted the shareholder's personal note in satisfaction of the shareholder's obligation as guarantor, the shareholder became the creditor of his corporation.[180] The Service concluded that the shareholder's basis in the obligation is equal to the face amount of his personal note.[181] The Service held that under the facts presented, on the date the corporation's note was canceled and the shareholder note was issued, shareholder indebtedness arose and the shareholder may deduct corporation operating losses against the newly created shareholder loan.[182]

One could question the existence of an economic outlay in the situation described in Revenue Ruling 75-144. Although the shareholder satisfied the corporation's indebtedness, it did not cost him anything. In light of the Service's position that an actual economic outlay is required before a shareholder can obtain basis under §1366(d)(1), it

172 I.R.C. § 301(c)(2), (c)(3) (1988).

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

174 *Id.*

175 *Id.*

176 *Id.*

177 *Id.*

178 *Id.* at 278.

179 *Id.*

180 *Id.*

181 *Id.*

182 *Id.*

is surprising that a substitution of notes would be satisfactory in garnering basis for the shareholder.[183]

Revenue Ruling 75-144 demonstrates the Service's willingness to use the concept of subrogation to allow a shareholder to obtain basis without an actual economic outlay. In the case of a renegotiated third-party loan where the shareholder substitutes his note for the corporation's note, the transfer of funds (actual economic outlay) likewise comes from the third-party lender. The shareholder who has substituted his note for a note of his corporation has parted with no more than he has parted with in the case of his guarantee of a third-party loan. Without some sound tax policy justification, it seems inconsistent that the Service would argue against a shareholder's use of the well established debt-equity concept in the case of a third-party loan.

Acceptance of the *Selfe* rationale could raise the issue of whether a deemed capital contribution cast in the form of a third-party loan creates a second class of stock.[184] The Service might argue that if the rights of the shareholders in their stock differ from the rights of the creditor with respect to the loan, treating the loan as a capital contribution creates a second class of stock, resulting in the termination of the S election.[185] However, it is unlikely that a third-party loan creates a second class of stock. The Code itself provides that straight debt will not be treated as a second class of stock.[186] A third-party loan would likely meet the definition of straight debt. Recently issued treasury regulations provide additional comfort that the *Selfe* rationale will not result in the termination of a corporation's S election.[187]

CONCLUSION

Subchapter C specifically authorizes the use of debt-equity principles to recharacterize a loan as a capital contribution. Section 1371 provides that unless inconsistent with provisions of subchapter S, the rules generally applicable to corporations and shareholders (i.e. subchapter C) apply to an S corporation as well. Therefore, unless there is a provision in subchapter S that is inconsistent with the application of debt-equity principles, §1371 demands that a third-party loan be treated as a capital contribution if the facts and circumstances warrant recharacterization.

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183 Revenue Ruling 75-144 is even more surprising when one considers the Service's conclusion in Rev. Rul. 81-187, 1981-2 C.B. 167. According to Revenue Ruling 81-187, no basis is obtained by a shareholder who transfers his promissory note to his S corporation. *Id.*

184 I.R.C. § 1361(b)(1)(D) prevents an S corporation from having more than one class of stock. *See* I.R.C. § 1361(b)(1)(D) (1988).

185 I.R.C. § 1362(d)(2) (1988).

186 I.R.C. § 1361(c)(5) (1988).

187 Treas. Reg. § 1.1361-1(c) (1992).

The *Leavitt* line of cases refuse to apply debt-equity principles in the case of third-party entity-level debt of an S corporation, either by rejecting outright the application of debt-equity principles or by requiring an actual economic outlay by the shareholder. The legislative history relied on by *Leavitt* is not conclusive. Indeed, the committee report language cited by *Leavitt* can easily be interpreted as approving the application of debt-equity principles.

Utilizing debt-equity principles would bring the tax treatment of S corporation shareholders closer to the tax treatment of partners in a partnership. This is the overriding purpose of subchapter S. Refusing to extend debt-equity principles to an S corporation only serves to frustrate this legislative purpose. It also creates complexity in the tax law, creates costly renegotiations of entity-level loan agreements, and causes unfair, anomalous results for taxpayers.

Regardless of the statutory support and the sound tax policy reasons for utilizing debt-equity principles in the case of third-party loans, taxpayers seeking to deduct corporate losses against stock provided by third-party loan transactions should proceed with caution. Simply guaranteeing a corporation's debt is not enough; facts and circumstances indicating the loan was, in substance, a capital contribution must be present before the *Selfe* rationale could be offered in support of the deduction. The safer approach would be to renegotiate the loan, changing the documentation to reflect the shareholder as the primary obligor. Any new debt financing should be structured as a loan from the bank to the shareholder, followed by either a capital contribution or a shareholder loan.

Perhaps a shareholder in an S corporation should be treated like a partner in a partnership with respect to entity-level indebtedness.[188] This approach would be consistent with the underlying purpose of subchapter S – allow the owners of a closely held corporation to choose to be treated as a partnership for tax purposes. No purpose is served by the current state of the law involving shareholder guarantees of S corporation debt, except to provide a trap for the unwary shareholder who failed to talk to his tax adviser before arranging financing at the bank. Once the shareholder discovers the potentially different tax treatment, he can correct his "mistake" by going to the bank and renegotiating the corporate debt. Unfortunately for the shareholder, substantial legal fees and finance charges may be incurred in the process.

If Congress were to adopt the partnership approach to determine an S corporation shareholder's basis for deducting losses, entity-level indebtedness of the corporation would be allocated to those shareholders who bear the risk of being called upon to pay

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[188] *See* John R. Dorocak, *Shareholder Guarantees of S Corporation Debt: Why Not Increase Basis?*, 4 J. S CORP. TAX'N. 56 (1992).

the debt. Only those shareholders guaranteeing a corporate debt would share in the allocation. Corporate losses could be deducted by a shareholder against basis provided by the debt. The amount realized on the sale of stock in an S corporation would include the shareholder's portion of guaranteed corporate debt, unless the selling shareholder remains liable on the guarantee. In other words, shareholders would be treated like partners with respect to guaranteed entity-level indebtedness.

Extending partnership treatment of entity-level debt to third-party loans to S corporations would bring the tax treatment of shareholders even closer to that of partners. Increasing a shareholder's tax basis for guaranteed loans without regard to debt-equity principles would further the tax policy underlying subchapter S. However, congressional action is necessary to effect such a change. In the mean time, accepting debt-equity principles in the subchapter S corporation context does justice to the taxpayer, to the statutory provisions currently in place, and to the legislative purpose underlying subchapter S.