Basis and S Corporation Shareholder Loans (Part I of II)

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Recently, the Tax Court spoke on an age-old question: Does a tax-motivated shareholder loan to an S corporation provide basis to the shareholder so that the shareholder can claim the S corporation's losses? That's a question that is as old as the hills, but the recent offering shows just how persistent this problem can be. In *S.P. Ruckriegel et al.*, 91 TCM 1035, Dec. 56,485(M), TC Memo. 2006-78, the situation was a bit more messy and complicated than usual. The Tax Court addressed this important topic in a thorough manner. At the very least, *Ruckriegel* provides a list of how (and how not) to plan effectively.

Sid Paul Ruckriegel and his brother, Al A. Ruckriegel, ("Sid and Al" or "the taxpayers") each owned 50 percent of Sidal, Inc., an S corporation which incurred ordinary losses. They were also 50-50 partners in Paulan Properties ("Paulan"), a general partnership that advanced funds to Sidal between 1997 and 2000. Sid and Al claimed that these advances resulted in basis-increasing loans from them to Sidal. Mechanically, in all but one instance, the payments were made directly by Paulan to Sidal ("Paulan direct payments"). In the other transfer, Paulan made payment indirectly through Sid and Al ("wire transfer payments").

If the advances were respected as back-to-back loans, they would have provided Sid and Al with sufficient basis to permit them to deduct their share of Sidal's ordinary losses. [*See* Code Sec. 1366(d)(1)(B).] Believing that the advances provided basis, Sid and Al claimed the losses. Not surprisingly, the IRS disallowed them on the grounds that they had a zero basis in their investments in Sidal.

The Players

Sidal, an S corporation since its organization in 1993, operated approximately 50 fast food restaurants throughout Indiana and Illinois. Although Sid and Al had always actively managed Sidal, the company operated at a loss. Paulan, a general partnership governed by Indiana law since its formation in 1993, owned real property which it leased to several of the restaurants operated by Sidal as well as to other restaurant operators. Sid and Al actively managed Paulan, but Paulan operated at a profit.

Fast food was a Ruckriegel family affair. Their mother, Lovella, had official control and management of Paulan, although she was not partner. Perhaps this was a safety measure to break deadlocks between her two sons. Lovella's duties consisted of receiving, depositing and recording incoming cash and writing and recording checks on Paulan's behalf.

Their father, Robert, together with Lovella, owned a controlling interest in BR Associates, Inc., a company that provided financial advice, bookkeeping, secretarial and administrative services to both Paulan and Sidal. BR Associates provided financial information to an outside CPA, Ralph Michel, who prepared tax returns for both Paulan and Sidal.

Prior Audits

The IRS audited both Sid and Al for tax years 1995 and 1996. The IRS denied their deductions of Sidal's 1995 and 1996 pass-through losses on the grounds that they each lacked sufficient basis in Sidal. Sid and Al paid the deficiencies.

After the audit, Michel spoke with the IRS agent who conducted the audit to determine if it were possible for Sid and Al to structure loans to Sidal to enable them to create basis. After that conversation, Michel advised Sid and Al that they could structure loans to Sidal to obtain basis. Between 1997 and 2000, the taxpayers made loans to Sidal in accordance with Michel's advice.

Sid and Al were audited again for tax years 1997 and 1998. This time the agent did not challenge their loss deductions. Unfortunately, when Sid and Al were again audited for tax years 1999 and 2000, the agent decided to take a closer look at their claimed basis.

Wayward Loans

On 11 occasions during the 1997 through 2000 period, Paulan transferred funds to Sidal

either directly or indirectly *via* Sid and Al. Paulan obtained the majority of these funds from unrelated banks, and it is worthwhile to take a brief review of these loans. In 1997, Paulan borrowed $6.5 million from the bank secured by assets of both Paulan and Sidal, and guaranteed by Sidal, Robert, Lovella, Sid and Al. Paulan then wrote a check to Sidal for $1.2 million, and both Sidal's and Paulan's trial balances reflected the loan.

During the years in question, Sidal made principal and interest payments directly to Paulan. Notably, neither Paulan nor Sidal adjusted its financial statements to recharacterize either the loan or any of the principal and interest payments to be consistent with a loan by Paulan to the taxpayers and then a loan by the taxpayers to Sidal. Also in 1997, Paulan wired $1 million to each Sid and Al, and each of them wired the money to Sidal. Yet, Sidal made principal and interest payments directly to Paulan in connection with the wire transfer payments.

During 1998, Paulan wrote checks totaling approximately $1 million to Sidal. Sidal's and Paulan's trial balances reflect a note payable between them for the balance. No adjusting entries were made on either trial balance to recharacterize Paulan's 1998 payments to Sidal as Paulan's loans to taxpayers and then as taxpayer's loans to Sidal.

The story remains much the same in 1999. Paulan borrowed $250,000 from Bavaria, Inc., a C corporation, the stock of which was wholly owned by Robert and Lovella. Paulan used the proceeds to write a check to Sidal for $250,000. Also in 1999, Paulan borrowed $525,000 from Civitas Bank and used the proceeds to write a check to Sidal for the same amount.

Although both Paulan's and Sidal's 1999 general ledgers reflected the two advances as resulting in a $775,000 payable from Sidal to Paulan, this time both made adjusting entries to reflect notes payable by Sidal to Sid and Al and notes receivable by Paulan from Sid and Al. In 2000, Paulan borrowed $1,350,000 from the bank and used the funds to write three checks to Sidal for $1.1 million. Although Sidal's trial balance originally reflected a note payable to Paulan for $1.1 million, adjusting entries were made to reflect notes payable to Sid and Al for $550,000 each.

For each advance over the four-year period, Sid and Al executed promissory notes to Paulan, and Sidal executed promissory notes to Sid and Al. However the timing of the notes was problematic. As we'll see below, several of the notes predated their corresponding advances.

The timing problem also surfaced in corporate and partnership minutes. For each Sidal promissory note, Sid and Al, in their capacities as directors of Sidal, executed minutes of a "Special Meeting of the Board of Directors of Sidal, Inc.," which purported to be the minutes of directors' meetings authorizing the borrowings and the promissory notes. In their capacities as the sole general partners of Paulan, Sid and Al executed analogous minutes for Paulan. However, the court was not pleased when it found out that none of the Sidal or Paulan minutes were drafted or executed earlier than June 2000.

Basis Creation

Code Sec. 1366(a) provides that a shareholder of an S corporation takes into account his *pro rata* share of the S corporation's items, but Code Sec. 1366(d) limits losses and deductions that a shareholder may take into account to the sum of (1) his adjusted basis in the stock of the S corporation and (2) his adjusted basis in any indebtedness of the S corporation to the shareholder. We all know that, right? Well, Sid and Al contended that all of the 1997 through 2000 payments were, in substance, direct loans from them to Sidal that increased their debt basis. In contrast, the IRS contended that all of the payments were loans from Paulan directly to Sidal that did not increase Sid and Al's debt basis in Sidal.

The parties made two types of advances: (1) wire transfer payments, which were payments made by Paulan to the taxpayers and, then, by the taxpayers to Sidal; and (2) Paulan direct payments, which were made by Paulan directly to Sidal. For Sid and Al to prevail, they needed to show that in substance they, not Paulan, made loans to Sidal, and that Sidal's resulting indebtedness ran directly to them. [*See, e.g., R.M. Prashker*, 59 TC 172, Dec. 31,583 (1972).] If instead Sidal's indebtedness ran to

Paulan, Sid and Al would not have basis in Sidal. [*See E.J. Frankel*, 61 TC 343, Dec. 32,250 (1973), *aff'd,* CA-3 (unpublished opinion), 506 F2d 1051 (1974).]

Furthermore, the advances had to create indebtedness from Sidal to the taxpayers on the dates of each payment to Sidal. Subsequent recharacterization of the payments as back-to-back loans, through Sid and Al, would not give them basis in Sidal. [*See M.G. Underwood*, CA-5, 76-2 USTC ¶9557, 535 F2d 309 (1976), *aff'g* 63 TC 468, Dec. 33,016 (1975); *A. Bhatia*, 72 TCM 696, Dec. 51,565, TC Memo. 1996-429.]

Substance vs. Form

Because the Paulan direct payments were in fact payments from Paulan directly to Sidal (and Sidal later repaid Paulan directly), Sid and Al had to prove that Paulan, in making those payments (and in receiving the repayments), was acting on their behalf (*i.e.*, as their agent) and that they were the actual lenders to Sidal. In other words, the Paulan direct payments had to create debt from Sidal to them, not to Paulan. The objective intent of the parties to create a debt is always important. [*See, e.g., Hubert Enters., Inc. & Subs.*, 125 TC 72, Dec. 56,145 (2005).] Thus, Sid's and Al's subjective beliefs were not necessarily determinative. Moreover, transfers between related parties need to be examined with special scrutiny.

Thus, in *D.J. Culnen*, 79 TCM 1933, Dec. 53,856(M), TC Memo. 2000-139, *rev'd on another issue*, CA-3, 2002-1 USTC ¶50,200, 28 FedAppx 116 (2002), the uncontradicted testimony was that the taxpayer had for many years used his controlled, profitable corporation as an incorporated pocketbook. The corporation made payments on his behalf that were posted to the corporation's books as loans to the taxpayer. This created a loan balance that the taxpayer would periodically liquidate by making payments to the corporation. The court found that in substance, the shareholder's advances to the corporation (which was an S corporation) constituted economic outlays or payments on the taxpayer's behalf, thereby creating tax basis for the taxpayer-shareholder. [*See also C.E. Yates*, 82 TCM 805, Dec. 54,523, TC Memo. 2001-280.]

The issue for the wire transfer payments was whether the payments were (1) in substance as well as in form back-to-back loans from Paulan to the taxpayers, and then from the taxpayers to Sidal, *or* (2) direct loans from Paulan to Sidal with the taxpayers serving as mere conduits for the transfer of funds. If the latter, the court would apply the step transaction doctrine to ignore the same-day wire transfers from Paulan to the taxpayers and then from the taxpayers to Sidal. [*See Aiken Industries Inc.*, 56 TC 925, Dec. 30,912 (1971).] If the court were to ignore Sid's and Al's participation in the transactions, then as in the case of the Paulan direct payments, the issue would become whether Paulan made funds available for the use of (and collected repayments of principal and interest from) Sidal as an agent for or on behalf of the taxpayers.

Global Corporate Issues

Before leaping into the IRS's challenges of Sid's and Al's claimed losses, it is worthy to take a step back to view the forest, instead of the trees. Sid and Al hoped that both the wire transfer payments and the Paulan direct payments would create basis for them so that they could claim the pass-through losses from their S corporation. The basis would be created by their direct and deemed debt contribution to Sidal.

Yet, the technique of contributing a note to generate basis is not limited only to S corporation shareholders. C corporation shareholders also attempt to create basis, but for different reasons. S corporation shareholders usually want basis to claim pass-through losses. C corporation shareholders want basis to avoid Code Sec. 357(c) gain.

M&A TAX REPORT readers know that Code Sec. 357(c) provides for gain recognition when property is contributed to a C corporation and the liabilities assumed by the corporation exceed the shareholder's basis in the contributed property. So, for example, a taxpayer would recognize gain of $30 when he contributes land to his C corporation that has a fair market value of $100, a basis of $60 and the corporation assumes the $90 mortgage on the land.

One method taxpayers have tried to avoid gain recognition in this situation is to contribute a note to the corporation in the amount of the potential gain simultaneously. Using the

same example as above, the taxpayer would contribute a note with a face value of $30 to the corporation. Assuming that the shareholder can claim basis in the note in the amount of its face value, no gain would result since the basis of the contributed property would equal liabilities contributed.

Historically, the IRS and the courts took the position that contributing one's own note to a corporation did not create basis. [*See* Rev. Rul. 68-629, 1969-2 CB 154; *V.W. Alderman*, 55 TC 662, Dec. 30,611 (1971) (gain recognized under Section 357(c) even though shareholder contributed note to corporate transferee for excess of assumed liabilities over asset basis; shareholder had zero basis in his own note).]

More recently, in *S. Lessinger*, CA-2, 89-1 USTC ¶9254, 872 F2d 519 (1989), *rev'g*, 85 TC 824, Dec. 42,489 (1985), the Second Circuit held that a corporation that receives a Code Sec. 351 contribution of a note has a basis in the note equal to the face amount of the note. The basis allowed Lessinger to avoid Code Sec. 357(c) gain. The Ninth Circuit also reached this result. [*D.J. Peracchi*, CA-9, 98-1 USTC ¶50,374, 143 F3d 487 (1998).]

Interestingly, the *Lessinger* court agreed with the IRS that a shareholder has a zero basis in his own note. However, a shareholder recognizes gain only to the extent the liabilities assumed by the corporation exceed the corporation's basis in the note and other property contributed to it. The court then held the corporation does not take a carryover basis in the contributed note (which would have been zero), but rather takes a basis equal to the note's face value. In contrast, the *Peracchi* court held that the shareholder takes a basis in his own note in the amount of the note's face value.

Economic Outlay Required

The IRS argued that Sid and Al failed to satisfy the requirement that an increased basis in an S corporation must entail an "actual economic outlay" by the shareholder. The IRS argued that this requirement is met only if the taxpayer invests in or lends to the S corporation his own funds, or funds borrowed from an unrelated party to whom he is personally liable. The Tax Court, however, rejected that view, noting that whether funds lent to an S corporation originate with another entity that is owned or controlled by the same shareholder does not preclude finding that the loan constitutes an "actual economic outlay" by the shareholder. [*See Yates*, *supra.*]

After all, it is not unusual for an individual to conduct multiple businesses through multiple entities, some or all of which are pass-through entities (*e.g.*, S corporations, LLCs or partnerships). One or more of those entities may be profitable, and one or more may not. Where the loss entity is an S corporation, the court found no categorical rule in any authorities, nor as a matter of "plain common sense" to require a shareholder to fund an S corporation's losses with money from his mattress or with funds borrowed by him from a bank or other unrelated party, rather than with funds obtained from another controlled entity.

Sid's and Al's argument that the Paulan direct payments constituted *bona fide* back-to-back loans was essentially premised on two grounds: (1) They had historically used Paulan as an "incorporated pocketbook" to discharge their personal obligations, and the advances to Sidal were merely another example of that practice; and (2) after the IRS's denial of their claim for basis for Paulan's pre-1997 advances to Sidal, the taxpayers (at their CPA's direction!) structured all subsequent Paulan advances to Sidal in a manner intended to constitute *bona fide* back-to-back loans. They argued that their intent was clearly manifested by the promissory notes, the minutes and the accounting for those advances by both Paulan and Sidal.

This article will be continued in the August edition of the M&A TAX REPORT.

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