# S Corporation Corner

## Mr. Hargis: The Basis of His Indebtedness

*By Nelson Toner*

During the long winters in Maine, I like to dream about the changes that I will make to my gardens once the snow melts and the frozen ground thaws. When this magic moment finally arrives (often, not until the beginning of May), I implement my plans to improve the gardens. I regularly move plants to more appropriate locations to improve the amount of sunlight they receive or to make the flowers on the plants more visible from a certain part of the house. My wife says that I am a tinkerer—perhaps because my plans are mostly experimental and do not always improve the overall look of my gardens. Nonetheless, I am annually challenged by my grand attempts at making my gardens more beautiful.

This proclivity to tinker and adjust also permeates the thoughts of Treasury and the IRS when a tax rule has proven to be too complex or unwieldy to use and understand. One such example is the rule for the ability of an S corporation shareholder to use losses and deductions allocated by the S corporation. In general, the ability to deduct allocated losses and deductions is limited to the shareholder's investment in the S corporation, including the amounts the shareholder has loaned to the S corporation. For many years, the determination whether a purported loan created an appropriate investment in the S corporation was based upon a court-developed doctrine because the Code and the Regulations provided no guidance. After years of the application of a court-developed rule, Treasury and the IRS decided to devise a new rule that would provide more certainty and clarification to the issue. This column begins with a general description of the deduction rules under Code Sec. 1366, then explains the court-developed doctrine and the Treasury and IRS response in new Regulations and concludes with an application of the court-developed doctrine and the rules in the Regulations to a recent Tax Court case dealing with these issues.

For each tax year, an S corporation allocates its items of income, loss, deduction or credit to each of its shareholders in accordance with stock ownership, and each shareholder must take into account his or her share of these tax items.[1] The amount of losses and deductions taken into account by a shareholder for any tax year cannot exceed (a) the adjusted basis of the shareholder's stock in the S corporation and (b) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (the "basis of indebtedness").[2] If a shareholder cannot use an allocated loss or deduction in one tax year, then the loss or deduction is carried

**NELSON TONER** is a Shareholder in the firm of Bernstein Shur in Portland, Maine.

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forward to future tax years and can be taken into account when the shareholder has adequate stock basis and basis of indebtedness. In other words, a shareholder's ability to deduct losses and deductions allocated by the S corporation to the shareholder is limited to the shareholder's "investment" in the S corporation.[3]

Prior to the issuance of new Regulations on July 23, 2014, neither the Code nor the Regulations defined the term basis of indebtedness under Code Sec. 1366(d).[4] In the absence of guidance, the courts developed the "actual economic outlay" doctrine. Under this court-developed doctrine, an investment by a shareholder in an S corporation created or increased basis of indebtedness only if the shareholder's investment in the S corporation constituted an actual economic outlay to the S corporation where (a) the shareholder was made poorer as a result of the investment and (b) the S corporation had an indebtedness to the shareholder.[5]

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Concerned about the possible complexity of the application of the actual economic outlay doctrine and uncertainty of the tax outcome when applied, Treasury and the IRS issued new Regulations under Code Sec. 1366(d) to clarify the definition of basis of indebtedness.[6] In general, the Regulations change the focus of the analysis from an economic outlay analysis to a determination of whether the debt is *bona fide* but retains the economic outlay analysis with regards to the guarantee of a corporate loan by an S corporation shareholder. The Regulations consist of a general rule that covers all indebtedness, a special rule for the guarantee of a loan to an S corporation by one of its shareholders and four specific examples concerning the implementation of these new rules.

Under the general rule, basis of indebtedness means the shareholder's adjusted tax basis in any *bona fide* indebtedness of the S corporation that runs directly to the shareholder.[7] The determination whether indebtedness is *bona fide* for these purposes is based upon general federal tax principles and depends upon all of the facts and circumstances.[8] The preamble to the Proposed Regulations cites several cases that describe and apply general federal tax principles to determine if indebtedness to the shareholder is *bona fide*.[9] For example, the preamble lists the *T. Mixon Est., Jr.* case, in which the Fifth Circuit listed 13 factors to consider when determining if an advance of funds from the shareholder to a corporation is a loan, including (a) the presence of a fixed maturity date, (b) the right to enforce payment of principal and interest, (c) the status of the contribution in relation to regular corporate creditors, (d) the intent of the parties, (e) inadequate capitalization of the corporation, (f) the ability of the corporation to obtain loans from outside lending institutions, (g) the extent to which the advance was used to acquire capital assets and (h) the failure of the corporation to make payments on the loan.[10]

The new Regulations also contain a special rule for guarantees. The guarantee of a loan to an S corporation by a shareholder of the corporation does not create or increase the shareholder's basis of indebtedness under Code Sec. 1366(d). Rather, the shareholder can increase his basis of indebtedness only if the shareholder makes a payment under the guarantee. The shareholder's basis of indebtedness is increased to the extent of the payment.[11] This is the actual economic outlay doctrine as applied to guarantees.

The four examples set forth in the Regulations clarify the application of these new rules in specific circumstances. The first example illustrates the application of the general rule when a shareholder transfers funds to the S corporation in the form of a loan. The example concludes that the determination whether the loan is a *bona fide* indebtedness (and therefore creates or increases the shareholder's basis of indebtedness) is based upon general federal tax principles and depends upon all of the facts and circumstances.[12] The second example illustrates the application of the general rule in a back-to-back loan transaction situation. In this example, the taxpayer is the sole shareholder of two S corporations, S1 and S2. S1 makes a loan to the taxpayer, and the taxpayer then loans these same funds to S2. The example concludes that the determination whether the loan from the taxpayer to S2 constitutes *bona fide* indebtedness is based upon general federal tax principles and depends upon all of the facts and circumstances.[13] As an extension of the applicability of this second example, the preamble to the Proposed Regulations states that these new rules also apply to the situation where the shareholder uses the "incorporated pocketbook" theory to increase or create basis of indebtedness when one S corporation makes a loan to another S corporation when both corporations are related to the shareholder.[14] For example, assume that the shareholder is the sole shareholder of an S corporation (A Corporation) and is also the sole shareholder of another

S corporation (B Corporation). A Corporation makes a loan to B Corporation. The shareholder argues that the loan was made on behalf of the shareholder and, therefore, in substance, the transaction should be viewed as a loan from A Corporation to the shareholder and then as a second loan from the shareholder to B Corporation. Under the new rules, this incorporated pocketbook transaction increases the shareholder's basis of indebtedness only if the transaction creates a *bona fide* creditor-debtor relationship between the shareholder and B Corporation.

The third example illustrates the application of the general rule when a loan between the two related S corporations is restructured. Under this example, S1 made a loan to S2. Later in the same year, S1 assigned its creditor position in the note to the taxpayer by distributing the note to the taxpayer. Under applicable local law, S2 was relieved of its liability to S1 and was directly liable to the taxpayer. The determination whether the restructuring of the note created a *bona fide* indebtedness from S2 to A is based upon general federal tax principles and depends upon all of the facts and circumstances.[15] The fourth example illustrates the application of the special rule for guarantees. Under this example, the taxpayer is a shareholder of the S corporation. The S corporation received a loan from a bank and the bank required the taxpayer to guarantee the loan. In accordance with the special rule in the Regulations, the guarantee of the loan did not create or increase the taxpayer's basis of indebtedness. When the S corporation could no longer make payments on the loan, the taxpayer, in the taxpayer's role as guarantor, began to make payments on the loan until it was fully repaid. The example concludes that the taxpayer increased the taxpayer's basis of indebtedness for each payment made to the bank.[16]

In December, the Tax Court issued a memorandum decision that applied the actual economic outlay doctrine where the sole shareholder of an S corporation was the co-borrower or guarantor of loans made to his S corporation.[17] This may be one of the last cases to apply the old rules concerning the basis of indebtedness of the shareholder (because of the effective date of the Regulations) and therefore its review is instructive, if for only historical purposes. Perhaps, even more instructive is to attempt to apply the rules of the Regulations to the facts of the case to determine if the outcome might be different.

In the case, Mr. Hargis owned all of the stock of several corporations (each an "operating corporation") that managed the daily business of running nursing homes. Each operating corporation made an S corporation election. For each nursing home, a separate limited liability company (the "nursing home LLC") owned the real estate and nursing home facility. Mrs. Hargis was a 25-percent member of each nursing home LLC. Each nursing home LLC rented the real estate and facility to the corresponding operating corporation.

When the revenues from operations were not sufficient to meet operating needs, an operating corporation borrowed money from three specific sources: (a) from the nursing home LLCs (the "LLC loans"), (b) from other operating corporations (the "intercompany loans") and (c) from banks and other lending institutions that were not affiliated with the operating corporations or the nursing home LLCs (the "commercial loans"). With regard to all of the LLC loans, the intercompany loans and some of the commercial loans, Mr. Hargis acted as co-borrower with the borrowing operating corporation. In each case, the lender advanced funds directly to the borrowing operating corporation. When payments were made on these loans, the borrowing operating corporation made payments from its own account directly to the lender. Mr. Hargis did not make any payments from his personal accounts. With regard to some of the commercial loans where Mr. Hargis was not a co-borrower, the lender required Mr. Hargis to act as guarantor.

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With regard to each of the loans, Mr. Hargis claimed an increased basis of indebtedness because he acted as co-borrower of the loan to the borrowing operating corporation or as a guarantor for the loan to the borrowing operating corporation and deducted losses against the increased basis of indebtedness. The IRS audited the joint income tax returns for Mr. and Mrs. Hargis for the calendar years 2007 to 2010, concluded that Mr. Hargis could not increase his basis of indebtedness in the operating corporations because he was a co-borrower or a guarantor of the loans, denied the deductions Mr. Hargis had taken and assessed additional tax on Mr. and Mrs. Hargis.

In the *Hargis* case, in order for Mr. Hargis to prevail, he needed to present evidence to prove he had made an actual economic outlay to the operating corporations when he signed as co-borrower on the loans and served as a guarantor on the commercial loans that (a) made him poorer as a result of his positions with regard to the loans

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and (b) made the operating corporations indebted to him. Mr. Hargis argued that by acting as a co-borrower on the loans, he was personally liable for any borrowed funds and that under applicable state law he was directly liable for repayment of the loans. In addition, he argued that the commercial lenders would not have made the loans to the operating corporations if he had not guaranteed some of the loans and placed his personal assets at risk. In the alternative, Mr. Hargis argued that the loans were, in substance, incorporated pocketbook transactions and should be treated as a loan from the lender to Mr. Hargis and then a loan of the same funds from Mr. Hargis to the borrowing operating corporation. The Tax Court disagreed. Mr. Hargis had a potential for liability, but such potential did not constitute an actual economic outlay. For all of the loans, the Tax Court found that the debt ran directly from the lender to the operating corporations; these were not loans to the S corporation by Mr. Hargis. Also, the Tax Court found that the promissory notes evidencing the loans showed the operating corporations obligated to the lender for repayment. Therefore, the Tax Court held that Mr. Hargis did not obtain or increase his basis of indebtedness by acting as a co-borrower or guarantor of the loans made to the operating corporations because he had not made an investment in the operating corporations that constituted an actual economic outlay and there was no indebtedness from the operating corporations to Mr. Hargis.

We now know the outcome of the *Hargis* case for the years under audit. Would the outcome be any different under the Regulations if the IRS had audited the 2015 calendar year returns of the operating corporations, assuming the same facts as presented in the *Hargis* case? The general rule applies to the loans in which Mr. Hargis was a co-borrower with the borrowing operating corporation. In order for Mr. Hargis to prevail, he must prove that the transaction caused a *bona fide* creditor-debtor relationship between Mr. Hargis and the borrowing operating corporation under federal tax principles and based upon all of the facts and circumstances. Mr. Hargis did not transfer any of his funds to any of the borrowing operating corporations. Each of the loans was evidenced by a promissory note and had a fixed maturity date. However, the parties on the notes were the lender and the borrowing operating corporation. Some of the operating corporations are described as thinly capitalized. The Court noted that there were no payments made on the LLC loans and the intercompany loans, and the lender charged no interest on these loans. The funds from the loans were used to cover operating expenses and not capital expenditures. Mr. Hargis made no payments to the lenders. Any payments to a lender were made by the borrowing operating corporation. Based upon these facts and circumstances, it appears that Mr. Hargis will have a difficult task to prove that the loans are *bona fide* indebtedness from Mr. Hargis to the borrowing operating corporations either in form or in substance (under the incorporated pocketbook theory). Only if he can show that these debts are *bona fide* can he increase his basis of indebtedness and then deduct the allocated losses and deductions.

The special rule applies to the loans where Mr. Hargis is the guarantor. Under the special rule in the new Regulations, the shareholder does not create or increase basis of indebtedness by merely acting as a guarantor. The Tax Court used this same test in the *Hargis* case. Therefore, Mr. Hargis does not create any basis of indebtedness for this role as guarantor of some of the commercial loans. He obtains no better result for the loans where he is the guarantor under the Regulations, as he did under the application of the actual economic outlay doctrine.

I believe that the new rules under the Regulations concerning the creation or increase in basis of indebtedness are beneficial. Different from my playful experimentation in my garden, this change has altered the approach to the determination of an increase or creation of basis of indebtedness. The new focus is on the true aspects (the *bona fides*) of the loan transaction and not on the economic condition of the shareholder who purportedly made the loan. Under the Regulations, the tax practitioner should be diligent to document the loan, help the client define the purposes of the loan and implement the mechanics of the loan so that it meets the general federal tax principles based upon all available facts and circumstances. Then, the tax practitioner has provided the client with the best chance to increase his or her basis of indebtedness under Code Sec. 1366(d) and the best chance to use allocated deductions and losses.

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## ENDNOTES

1. Code Sec. 1366(a)(1).
2. Code Sec. 1366(d)(1).
3. S. Rept. 1983, 85th Cong., 2d Sess. 219–220 (1958) (1958-3 CB 922, 1141).
4. Notice of Proposed Rulemaking, REG-134042-07 (June 12, 2012).
5. *See D.G. Oren*, CA-8, 2004-1 USTC ¶50,165, 357 F3d 854, 857–859 . The *Hargis* case cites several other cases applying this doctrine.
6. Reg. §1.1366-2(a)(2).
7. Under the general rule, the former "actual economic outlay" doctrine no longer applies.
8. Reg. §1.1366-2(a)(2)(i).
9. Notice of Proposed Rulemaking, REG-134042-07 (June 12, 2012).
10. *T. Mixon Est., Jr.,* CA-5, 72-2 USTC ¶9537, 464 F2d 394, 402. For the tax practitioner, research should first be focused on cases in the taxpayer's jurisdiction and, if none, then to other jurisdictions.
11. Reg. §1.1366-2(a)(2)(ii).
12. Reg. §1.1366-2(a)(2)(iii) Example 1.
13. Reg. §1.1366-2(a)(2)(iii) Example 2.
14. Notice of Proposed Rulemaking, REG-134042-07 (June 12, 2012).
15. Reg. §1.1366-2(a)(2)(iii) Example 3.
16. Reg. §1.1366-2(a)(2)(iii) Example 4.
17. *B.R. Hargis*, 112 TCM 681, Dec. 60,765(M), TC Memo. 2016-232 (Dec. 21, 2016).

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