



Whose Debt Is it Anyway? S Corporation Borrowing from Related Entities
April 29, 2006



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Shareholder Debt or Not?

This week we consider the issues raised in the recent case of *Ruckriegel v. Commissioner*, TC Memo 2006-78 where two brothers owned interests in both an S corporation and a partnership. The partnership was generally profitable, while the S corporation had a steady stream of losses. The taxpayers advanced money from the partnership to the S corporation, but attempted to claim, through after the fact documentation and journal entries for the debts to truly be from the partnership to them individually, and then from them to the corporation in order to establish basis to take the losses.

Background

S corporation losses are limited by §1361(d)(1) to the shareholder's basis in stock and debt, as noted below:

1366(d)(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 -

1366(d)(1)(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and

1366(d)(1)(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).

A number of cases have dealt with just what qualifies as indebtedness of the S corporation shareholder, and those cases have made it clear that a very narrow definition will be applied. In general, indirect loans from entities the taxpayer controls will not work, nor will taxpayer guarantees of indebtedness of the corporation.

Our Case

The taxpayers in the case in question had been made aware of this issue in a previous examination of their returns where their losses were disallowed. It had been their routine to have the partnership simply advance money to the corporation when it needed the funds and the agent indicated that this would not create basis, and so disallowed losses for the years in question.

Their longtime outside accountant (Michel) who advised the brothers on tax matters discussed with the agent examining their returns how this issue could be resolved, and court noted the resolution of those years as follows:

After that audit, Michel spoke with the Internal Revenue Service (IRS) agent who conducted the audit regarding the proper way to structure future loans to Sidal so as to enable petitioners to achieve bases in Sidal equal to the loan amounts. In 1997, after that conversation, Michel advised petitioners that loans to Sidal could be structured to obtain tax bases for them in Sidal, and he advised them regarding that structure. The 1997-2000 loans to Sidal were structured in accordance with Michel's advice. The IRS agent auditing petitioners' 1997 and 1998 tax years did not challenge petitioners' passthrough deductions of Sidal's losses to the extent of petitioners' bases in Sidal attributable to (1) \$1 million wire transfers from Paulan to each petitioner and from each petitioner to Sidal on November 24, 1997 (the wire transfer payments), and (2) a \$200,000 capital contribution by each petitioner to Sidal on July 11, 1997.

An important fact to note on these transfers is that the money went from their partnership (Paulan) to the stockholders, and then was transferred to the corporation (Sidal).

Later Years

Unfortunately, the brothers went back to the old method of handling their finances from then forward. The controller for their businesses generally recorded the debts as direct debts from the partnership to the corporation. As well, all interest payments were made directly from the corporation to the partnership, and the corporation did not issue a 1099-INT to the brothers each year indicating it had paid them interest income. The inside accountant indicated that he relied on the outside CPA to handle all tax matters and concentrated on recording cash flows.

Michel, the outside tax CPA, each year recorded adjusting journal entries that treated these obligations as being two separate obligations—one being a loan taken from the partnership by the brothers, and then a second obligation from the corporation to the brothers in an equal amount. As well, sometime after the transactions in question the brothers and the entities signed notes evidencing this treatment, and the transaction was reflected in special meeting minutes of the corporation. Michel believed that by doing this the brothers now had basis, based on his conversation with the agent.

The IRS disagreed, indicating that merely “papering over” this transaction was not sufficient to create basis and, in fact, attempted to claim that even in one case when the cash had been transferred from the partnership to the brothers and then to the corporation that the brothers were a “mere conduit” and no true debt existed then either.

The Court’s View

The court did not fully agree with either party, but rather ultimately looked at the form of the original transactions, an analysis that worked against the brothers far more often than it did against the IRS.

For those transactions where the funds went directly from the partnership to the corporation, the court outlined what the brothers had to prove to carry this issue as follows:

Because the Paulan direct payments were, in fact, payments from Paulan directly to Sidal (and Sidal repaid Paulan directly), petitioners must prove that Paulan, in making those payments (and in receiving the repayments), was acting on behalf of (i.e., as agent of) petitioners, who were the actual lenders to Sidal. Put another way, petitioners must establish facts sufficient for us to draw the legal conclusion that, on account of the Paulan direct payments, Sidal was indebted to them, not to Paulan. Petitioners claim that it is Indiana law that governs whether a debtor-creditor relationship exists and, under Indiana law, intent governs.

The brothers argued that, under Indiana law, these would be true debts owed by them to the partnership, followed by true debts from the corporation to them due to what they claimed was their intent at the time. The Tax Court agreed that intent was important, but clarified that the taxpayers’ statements and beliefs did not absolutely establish that intent:

Intent is, indeed, important. We have said: "Whether a transfer of money creates a bona fide debt depends upon the existence of an intent by both parties, substantially contemporaneous to the time of such transfer, to establish an enforceable obligation of repayment." *Delta Plastics Corp. v. Commissioner* [Dec. 30,175], 54 T.C. 1287, 1291 (1970). We also agree with the Supreme Court of Indiana that we must make an objective appraisal of intent. See, e.g., *Hubert Enters., Inc. & Subs. v. Commissioner* [Dec. 56,145], 125 T.C. 72, 91 (2005) ("The subjective intent of the parties to a transfer that the transfer create debt does not override an objectively indicated intent to the contrary."). Thus, petitioners' beliefs are not necessarily determinative.

The Court also notes that if the taxpayers are attempting to argue substance over form, they have a problem since they controlled the form (an issue we've discussed before).

Their position was a two-pronged justification for the reality of the loans from the brothers:

Petitioners' argument that the Paulan direct payments constituted bona fide back-to-back loans through them individually is essentially premised on two grounds: (1) Like the taxpayers in *Yates* and *Culnen* they have historically used Paulan as an "incorporated pocketbook", to discharge their personal obligations, and the advances to Sidal are merely another example of that practice; and (2) after respondent's denial of shareholder basis for Paulan's pre-1997 advances to Sidal, petitioners, at Michel's direction, structured all subsequent Paulan advances to Sidal in a manner intended to constitute bona fide back-to-back loans, an intent that was clearly manifested by the promissory notes, the minutes, and the accounting for those advances by Paulan and Sidal.

The brothers have indicated that they intended to rely on two cases that referred to "incorporated pocketbooks" where the corporation was the alter-ego of the individual to support their position that even if the court were to find the form of the transactions was to be based on the original recording on the books.

The Court notes that:

In *Culnen v. Commissioner*, T.C. Memo. 2000-139, revd. on another issue 28 Fed. Appx. 116 (3d Cir. 2002), the uncontradicted testimony was that the taxpayer had for many years used his controlled, profitable corporation as an incorporated pocketbook, having the corporation make payments on his behalf that were posted to the corporation's books as loans to the taxpayer, creating a loan balance, which, periodically, the taxpayer would liquidate by making payments to the corporation. We found that, in substance, the corporation's advances to a loss corporation (an S corporation) in which the taxpayer was a shareholder constituted economic outlays or payments on the taxpayer's behalf, thereby creating a tax basis for the taxpayer in the S corporation under section 1366(c)(1)(B). We reached a similar conclusion in *Yates v. Commissioner*, T.C. Memo. 2001-280.

The Accountants' Fix—Did It Work?

The second option looks at whether the “paper trail” is effective for these transactions. The first issue involved the promissory notes, and the Tax Court had problems with these notes, since they appeared to be executed after the fact:

Neither petitioner could recall the actual dates upon which the promissory notes were executed. They could only agree that the notes were executed sometime between 1997 and 2000. We infer from that testimony that the notes were not executed contemporaneously with the wire transfer and the Paulan direct payments but were, instead, backdated to appear contemporaneous with those payments. Moreover, none of the eight sets of promissory notes bears an effective date that corresponds to the Paulan direct payment to which it relates.

Five sets of notes bear effective dates that are between 3 days and more than 9 months subsequent to the corresponding Paulan direct payments. Even if we were to accept as accurate the stated effective dates of those notes, the notes are more reflective of attempts to recharacterize prior debts from Sidal to Paulan as back-to-back loans through petitioners than they are of back-to-back loans as of the dates of the actual Paulan direct payments. Therefore, at best, those notes suggest the creation of a back-to-back loan structure after the Paulan direct payments to which they relate. Such a finding would not justify treatment of those notes as anything more than guaranties of Sidal's existing indebtedness to Paulan, which would be ineffective to create bases in Sidal under section 1366(d)(1)(B). See *Bergman v. United States*, 174 F.3d 928 (8th Cir. 1999); *Underwood v. Commissioner*, 535 F.2d 309 (5th Cir. 1976).

Conversely, the other three sets of promissory notes predate the Paulan direct payments to which they relate. Those promissory notes also fail to support a finding that the corresponding Paulan direct payments, in substance, created bona fide indebtedness from Sidal to petitioners and from petitioners to Paulan in the amounts set forth and on the dates thereof. See *Perry v. Commissioner*, 392 F.2d 458 (8th Cir. 1968) (predated notes insufficient to prove indebtedness from an S corporation to the taxpayer shareholder), affg. [Dec. 28,180] 47 T.C. 159 (1966); *Thomas v. Commissioner*, T.C. Memo. 2002-108 (promissory note bearing a date prior to the transaction to which it relates given no weight), affd. 67 Fed. Appx. 582 (11th Cir. 2003).

The minutes also appeared to be similarly problematical:

The Paulan minutes, in essence, reflect meetings at which petitioners, acting on behalf of Paulan, authorized loans to themselves individually, and the Sidal minutes, in essence, reflect meetings at which petitioners, acting on behalf of Sidal, authorized borrowings from themselves individually. As mere authorizations, those meetings are not evidence that the loans, in fact, occurred, but they can be evidence of an intent to make the loans.

The purported meeting dates all precede the stipulated date(s) when the minutes were drafted. Although it is necessarily the case that meeting minutes cannot be drafted until after the meeting, we give little or no evidentiary weight to minutes that follow the alleged meetings to which they relate by periods of anywhere from a month to more than 3 years. Those delays, in this case, indicate an attempt to provide an after-the-fact paper trail of back-to-back loans through petitioners rather than corroboration of an actual intent to make such loans, which existed at the time of the Paulan direct payments. Even the Sidal minutes drafted with respect to the October 31, 2000, Paulan direct payments are stipulated to have been "drafted and executed sometime after * * * [that date]." There is no evidence as to how long after October 31, 2000, the minutes were drafted. Therefore, we have no reason to give more evidentiary weight to those minutes than to the minutes relating to the earlier payments.

We also note that, because the minutes of each of Sidal's board of directors meetings specify as the meeting date the alleged effective date of the corresponding set of promissory notes, five of the eight Sidal board meetings are necessarily alleged to have been held after the borrowings authorized during those alleged meetings. (As noted supra, five of the eight sets of promissory notes bear effective dates subsequent to the Paulan direct payment(s) to which they relate.) Because after-the-fact authorizations (as opposed to genuine ratifications) are not credible, that aspect of a majority of the minutes further supports our conclusion that the minutes merit little or no evidentiary weight. In fact, it supports the conclusion that none of the alleged Paulan or Sidal partner/board meetings actually took place in the manner or at the times stated in the minutes.

The accounting records are the final item considered on this issue. The controller for the organizations was recording the direct transfers as loans between the entities, but the CPA and the inside accountant both sought to discount those entries.

However, the Court indicated that Michel's entries had to be discounted because he was the only person who seemed involved with those entries—the taxpayers had not directed him to make them:

Moreover, in each of Yates, and Culnen, the taxpayer-shareholder was intimately involved in recording the intercompany advances to the S corporation as giving rise to payables from the S corporation to him. In Yates, it was the taxpayer who directed his accountant to make intercorporate funds transfers and, by yearend, to record those transfers either as distributions to him followed by capital contributions to the payee S corporation or as back-to-back loans to the S corporation through him. In Culnen, the taxpayer's regular accountant testified that it was the taxpayer who routinely, over a 20-year period, directed the bookkeeper for the payor corporation to have that corporation write checks on his behalf and charge the amounts to his loan account with the corporation; and the taxpayer's outside accountant testified that she made the adjusting entries

classifying the payor corporation's payments to the loss S corporation as back-to-back loans through the taxpayer on the basis of conversations with the taxpayer. In this case, there is no evidence that petitioners were even aware of the Paulan and Sidal accounting entries designed to show back-to-back loans through them or of the fact that the appropriate adjusting entries were not made in connection with the July 11, 1997 and 1998, Paulan payments to Sidal. Rather, the testimony at trial indicated that petitioners relied completely upon Michel for all tax planning, and that it was Michel who, alone, was responsible for making the accounting entries consistent with his plan to generate tax bases for petitioners in Sidal. Petitioners, who lacked any hands-on involvement with the accounting for the Paulan direct payments, cannot, like the taxpayers in Yates, and Culnen, rely on those accounting entries to prove the existence of binding debt obligations from Sidal to them and from them to Paulan arising out of those payments on the dates thereof.

Incorporated Pocketbook

In the cases the taxpayer attempted to rely upon for the theory that their corporation regularly acted on their behalf there was a large number of different transactions that were paid out of the corporation on behalf of the shareholder. The court found that, in this case, the payments in question didn't show that pattern:

We do not consider the 31 checks as anything other than distributions of accumulated profits or, if more than accumulated profits, as return of capital. Being written to petitioners, those checks are not evidence of their use of Paulan as an incorporated pocketbook; i.e., to make payments directly to third parties on behalf of one or the other of petitioners. Moreover, the 24 Paulan checks paid over a 5-year period for petitioners' taxes and insurance (approximately five checks a year) are not of a volume or of such a general nature that we are convinced that Paulan habitually paid petitioners' bills. In sum, the 55 checks and the conclusions to be drawn from them are insufficient to convince us that the Paulan direct payments were made by Paulan to Sidal on petitioners' behalf.

Conclusion

The court indicates that, in this case, paying attention to detail was important—and was something the taxpayer and their adviser failed to do:

For the reasons stated, we find that, despite petitioners' overall intent to take the steps necessary to establish tax bases in Sidal beginning in 1997, the steps taken (the promissory notes, the minutes, and the accounting entries) were ineffective to carry out that intent. At best, those steps amounted to a reclassification of initial indebtedness from Sidal to Paulan. Put quite simply, petitioners, in conjunction with Michel, paid insufficient attention to detail. Another example of that failing is exemplified by the failure to have Sidal issue information returns (IRS Forms

1099) to petitioners in connection with its interest payments (actually made to Paulan) on the alleged indebtedness.

What we can take from this case is that S corporation indebtedness/basis issues are not an area where “close” is good enough. We have to avoid the temptation to “solve” the client’s problems by attempting to make the record reflect what they taxpayer should have done—especially when the taxpayer him/herself doesn’t want to be bothered with the details.