

TAX UPDATE

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Is It Really My Loan? S Corporation Debt Once Again

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S Corporation Loans

The Tax Court again picked up on an issue they seem to run into quite often—the issue of whether a taxpayer with a loss S corporation could take that loss by claiming to have basis in debt. This week, the case of *Miller v. Commissioner*, (TC Memo 2006-125) the Tax Court decided in favor of a taxpayer's right to claim losses against debt, ruling both that the debt was truly from the taxpayer to the corporation and that he was truly at risk under §465 for the debt in question.

Basic Issues for S Corporation Basis

We last visted this matter not terribly long ago when we considered the *Ruckriegel v. Commissioner* case back in late April. As noted then, the basic law is found in §1366(d)(1) which provides:

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).

§1366(d)(1)(B) has been the significant tripping point, since the provision requires that the debt be literally from the S corporation to the shareholder. Guarantees don't count, and neither does "indirect" debt from another entity that may be under control of the taxpayer (the issue in *Ruckriegel*).

What this means is that, for this provision, form is incredibly important—relationships that may be, in substance, virtually identical can produce radically different tax results.

Miller's Facts

Mr. Miller was the majority shareholder in Miller Medical Systems (MMS) which manufactured mobile and modular medical diagnostic facilities. Mr. Miller found four outsider investors who contributed capital to MMS on the condition that the corporation obtain a \$1 million line of credit from its bank, which it did.

Mr. Miller guaranteed this debt in full, while his co-investors each guaranteed a limited amount of the debt, but as we noted that's not good enough to use as basis for the purposes of generating deductions. MMS operated in the red, and through 1991, Mr. Miller had losses from the S corporation that were being held in suspense for lack of basis of over \$600,000. As the end of 1992 approached, it became clear that MMS would again generate a loss, so Mr. Miller sought advice on how to proceed.

Mr. Miller was advised by his tax adviser at Ernst & Young that the loan needed to be restructured if he was going to be able to take advantage of those losses. The adviser wrote a letter to the bank explaining the situation, proposed a solution where the debt would be reissued to Mr. Miller who would then loan the funds to the corporation, and noted that the transaction had to take place before December 31, 1992.

The court noted the following actions the bank took in response to that letter:

In response, Huntington agreed to reissue the line of credit to petitioner personally with essentially the same terms and conditions (including the Rapp Group guaranties) as the MMS/Huntington Loan, with certain additional conditions. First, all funds drawn by petitioner on the personal line of credit were required to be deposited into a restricted account in petitioner's name at the bank, all withdrawals from the restricted account were required to go into an

account at the bank maintained by MMS, and petitioner would be required to warrant that all draws on the personal line of credit would be used exclusively for MMS's construction costs for diagnostic units under contract. Second, rather than petitioner's making cash contributions to MMS, petitioner would extend a \$1 million line of credit to MMS (to be funded by petitioner's line of credit with Huntington) for which MMS would execute a promissory note and security agreement in favor of petitioner. MMS would provide as security for the line of credit to it from petitioner the same collateral as had secured MMS's original line of credit from Huntington. Finally, rather than have MMS serve as guarantor with respect to the line of credit extended by Huntington to petitioner, petitioner would instead make a collateral assignment to Huntington of all of petitioner's rights under the security agreement given to petitioner by MMS for the line of credit running between them, as well as a collateral assignment of the promissory note executed by MMS in favor of petitioner.

The Court noted that the bank put restrictions on the loan to insure the funds were only used by the corporation:

Both the Miller/Huntington and MMS/Miller Loans were due on December 31, 1993, and carried the same interest rate as the MMS/Huntington Loan (one-half point above Huntington's prime rate), with interest payable monthly and advance payments of principal permitted. The Miller/Huntington and MMS/Miller Loans contained the same limitation on advances as in the MMS/Huntington Loan; namely, advances could be made from Huntington to petitioner, and from petitioner to MMS, only with respect to a maximum of \$250,000 to cover MMS's construction costs for diagnostic facilities under contract. Pursuant to the conditions imposed by Huntington in agreeing to restructure the line of credit, the advances to petitioner under the Miller/Huntington Loan were deposited into a restricted account in petitioner's name for transfer to MMS. Similarly, when MMS made a payment with respect to its obligation to petitioner under the MMS/Miller Loan, such payment was required to be deposited by petitioner into a restricted account and held in trust for Huntington.

As security for the MMS/Miller Loan, MMS granted petitioner a security interest in the same collateral that had secured the MMS/Huntington Loan; namely, all of its assets, including equipment, inventory, accounts receivable, etc. In the security agreement for the Miller/Huntington Loan, petitioner made a collateral assignment to Huntington of all of his rights under the MMS/Miller Loan, including the promissory note executed in his favor by MMS....

Petitioner agreed to certain covenants with respect to the Miller/Huntington Loan, including covenants that, other than the extension of credit by petitioner to MMS under the MMS/Miller Loan line of credit, petitioner would not, and would cause MMS not to, lend or incur indebtedness (except indebtedness for

the purchase of property equal to the purchase price). Petitioner was also required under the Miller/Huntington Loan to submit MMS's financial statements and a report of MMS's accounts receivable to Huntington on a monthly basis, and to submit his personal financial statements as Huntington might from time to time require. No covenants had been required of petitioner as guarantor of the MMS/Huntington Loan. The Miller/Huntington Loan further provided that an event of default would exist if either petitioner or MMS became insolvent, or if MMS failed to comply with any provision of the MMS/Miller Loan.

So at the end of the day, it could be argued that not much except the form had changed. The bank still had an identical security interest in the assets it had before, under the collateral assignment had access to the rights that Mr. Miller had on this note in the event of default, and had covenants that “looked through” Mr. Miller to see what was happening inside MMS—even to the point of allowing that the insolvency of MMS would be a default event.

MMS continued to lose money, and eventually became insolvent, triggering a default under the loan. At that point, the following situation unfolded:

In December 1994, MMS became insolvent. At that time, there was an outstanding balance of \$1,375,000 on the Miller/Huntington Loan. On December 29, 1994, the Rapp Group, as guarantors, paid \$900,000 to Huntington in partial satisfaction of the Miller/Huntington Loan. The Rapp Group then satisfied the remaining \$475,000 on the Miller/Huntington Loan by taking out personal loans from Huntington and using the proceeds to purchase the Miller/Huntington Loan note.¹⁰ Concurrently, petitioner and the Rapp Group formed a new entity operating under the name MSR Technologies, LLC (MSR), which purchased MMS's remaining assets and completed MMS's outstanding contracts. Upon MSR's completion of the contracts, MSR paid the proceeds to the Rapp Group, which in turn used the proceeds to repay their personal loans from Huntington.

As of the trial in this case, petitioner had not made any payments to the Rapp Group to reimburse them for their payments to satisfy the Miller/Huntington Loan pursuant to their guaranties, nor had the Rapp Group sought reimbursement from petitioner.

Mr. Miller ended up reporting the following items on his tax returns, which became the issue of the dispute with the IRS:

Reflecting the outstanding balances on the Miller/Huntington Loan and the MMS/Miller Loan at the end of 1992, 1993, and 1994 of \$750,000, \$1,184,930, and \$1,375,000, respectively, petitioners claimed basis in indebtedness from MMS of \$750,000 as of December 31, 1992, as well as annual increases of \$434,930 as of December 31, 1993, and \$190,000 as of December 31, 1994.

Petitioners consequently deducted ordinary corporate losses from MMS in the amount of \$750,000 for 1992, \$431,691 for 1993, and \$189,845 for 1994. These deductions produced net operating loss carryback deductions of \$485,303 for 1989, \$87,174 for 1990, and \$83,018 for 1991, as well as net operating loss carryover deductions of \$238,293 for 1994 and \$206,178 for 1995.

Petitioners in addition claimed a net short-term capital loss of \$5,849 and a long-term capital loss carryover of \$8,194 for 1994, both of which were subsequently carried over into 1995.

Petitioners did not report any interest income incident to the MMS/Miller Loan on their 1993 return. On their 1994 return, petitioners reported \$109,674 of taxable interest income attributable to MMS.

Was it Mr. Miller's Debt?

The IRS first claimed that this debt was not truly debt from Mr. Miller to the corporation and, therefore, Mr. Miller had not basis against which to claim the losses noted above.

The Court, citing *Gilday v. Commissioner*, T.C. Memo. 1982-242, noted that substitution of a note was accepted as a method to come into compliance with §1366(d)(1)(B) as long as the transaction had some economic substance to it. Applying *Gilday* to this fact pattern, the court noted:

Viewing the restructuring of the line of credit as a whole, we believe that under the principles of *Gilday v. Commissioner*, supra, and *Raynor v. Commissioner*, supra, petitioners are entitled to the basis they have claimed. The December 30, 1992, transaction conformed in all material respects to the note substitution in *Gilday*. Petitioner gave his fully recourse \$1 million promissory note to Huntington to replace MMS's promissory note of like amount on which he had formerly served as guarantor. Huntington thereupon advanced \$750,000 under petitioner's note and recorded MMS's note as satisfied by virtue of the payment of its \$750,000 outstanding balance. MMS in turn gave a promissory note to petitioner which mirrored the terms of petitioner's note to Huntington. Participating in the foregoing transactions was an independent, third-party lender, a factor "critical to the result in *Gilday*". *Bergman v. United States*, supra at 933; see also *Oren v. Commissioner*, T.C. Memo. 2002-172. As in *Gilday*, a principal motivation for the note substitution was to generate basis for purposes of section 1366(d)(1)(B).

The IRS attempted a "substance over form" argument, claiming the rights the bank obtained were such that it was, for all practical purposes, the real lender to the corporation. The court did not agree, noting:

Respondent further contends that MMS, not petitioner, was in substance the borrower from Huntington because petitioner was required by Huntington to

assign to Huntington the MMS/Miller promissory note. Because of the assignment, Huntington "essentially owned and controlled" the note MMS executed in favor of petitioner and was its "beneficial owner", respondent argues. By contrast, petitioners maintain that petitioner made only a collateral assignment of the note. We agree with petitioners.

The Court explained the importance of the collateral assignment as follows:

The security agreement clearly sets forth a collateral assignment of a security interest in the note. Moreover, a Uniform Commercial Code financing statement was filed on December 31, 1992, to perfect Huntington's security interest in the "Commercial Loan Note executed by Miller Medical Systems, Inc. on or about December 30, 1992". Thus, respondent's repeated contention that "at any given point in time, Huntington held promissory notes for the identical amount due it from both Mr. Miller and MMS" is simply wrong; it is inconsistent with the rights and obligations effected in the restructuring. After the restructuring, MMS would become directly liable to Huntington only in the event of a default by petitioner or MMS. Absent default, MMS was directly liable to petitioner, not Huntington. Consequently, petitioner's collateral assignment of the MMS/Miller promissory note to Huntington provides no grounds for disregarding the separate indebtedness running between MMS and petitioner, and between petitioner and Huntington.

The court also dismissed the IRS's argument that the lender was looking principally to MMS as the source of funds to repay the loan, noting that while the issue had been considered in some cases, that was principally where the individual *and* the corporation were jointly liable on the loan. In that case, the issue of where repayment was expected to come from indicated that the shareholder was a mere guarantor—however, in this case the loan only was to the shareholder.

The Court also did not hold it against the taxpayer that he had failed to report interest income in 1993, essentially arriving at a "no harm, no foul" position, a position that might be viewed as generous. The taxpayer did have a risk here that the Court might use this to show that the loan was not as written—but the fact that other actions were consistent with the loan treatment likely had a major influence in the Court dismissing this as a "foot fault" rather than a fatal error.

The court also explained the difference between this case and the case of *Grojean v. Commissioner*, T.C. Memo. 1999-425. In *Grojean* the taxpayer acquired a participation interest in the loan the bank had made which the Court noted was a substantively different form of transaction than it had in *Miller*. Once again, we are reminded that form is very important here, even if the substance of transactions appears very similar.

At Risk Issues

The IRS next attempted to disallow the losses by arguing that Mr. Miller was not at risk

for these loans because he was protected from loss on the loans, based on guarantee waivers signed by the investors (the “Rapp Group”) who guaranteed the loan. The Court summarized the IRS position as follows:

Respondent argues that petitioners were not "at risk" with respect to the Huntington indebtedness because the guarantor waivers executed by the Rapp Group resulted in petitioners' being "protected against loss" within the meaning of section 465(b)(4). In respondent's view, because the Rapp Group waived any right of recovery from petitioner in the event that they were required to perform under their guaranties, petitioners faced no realistic possibility of loss with respect to the amounts borrowed from Huntington and, therefore, may not deduct losses attributable thereto. As part of his argument, respondent maintains that petitioner was a third-party beneficiary of the contract embodied in the guarantor waivers, and could therefore have defeated any action by the Rapp Group to recover from him the amounts they paid to Huntington under their guaranties.

However, the Court noted that Mr. Miller was exposed to risk even if he, in fact, could not have been forced to reimburse the Rapp Group:

Even assuming arguendo that the Rapp Group was effectively precluded from obtaining any reimbursement from petitioner of their guaranty payments, we do not agree that this factor eliminated any realistic possibility of loss by petitioner with respect to the Miller/Huntington Loan. Under the Miller/Huntington Loan, petitioner was the primary obligor on a recourse basis. He gave a second mortgage on his residence to secure his obligation. It is true that when MMS declared insolvency (which was an event of default under the Miller/Huntington Loan), Huntington in fact sought and obtained recovery from the Rapp Group guarantors, presumably because at that time petitioner's net worth, disregarding the Miller/Huntington Loan, was \$273,000, consisting primarily of relatively illiquid assets such as the equity in his residence, an automobile, and items of personal property. However, had petitioner's financial circumstances been different, Huntington was entitled to seek full or partial recovery from him and quite possibly would have done so. In short, there was no certainty that the guarantors would be called upon to satisfy the indebtedness. As a consequence, we conclude that petitioner had a realistic possibility of loss thereon.

Forgiveness of Debt Income

The Court did find that there was forgiveness of debt income for Mr. Miller in 1994. The court noted:

The only evidence supporting the contention that petitioner remained liable to the Rapp Group for \$900,000 is his self-serving testimony to that effect. We are not required to accept such testimony. See *Tokarski v. Commissioner*, 87 T.C.

74, 77 (1986). Balanced against petitioner's testimony are, first, the terms of the guarantor waivers, under which the Rapp Group waived any right of indemnification or reimbursement (or subrogation from Huntington) against petitioner that would otherwise arise by virtue of any payment under their guaranties. Second, in the more than 8 years between the Rapp Group's payment under their guaranties and the trial in this case, the Rapp Group did not seek reimbursement from petitioner, nor did petitioner make any payment in satisfaction of his purported liability to them.

However, the Court then went on to find that Mr. Miller was insolvent at the time of the forgiveness of indebtedness. Even though a financial statement prepared by Mr. Miller at end of 1994 showed the debt on the bank loan as a contingent liability rather than an actual one, the Court nevertheless agreed that, in fact, it was his debt and he was insolvent at the time of forgiveness.

Although that dodges the large inclusion of income on 1994, there are consequences going forward which the Court noted:

Any amount excluded under section 108(a)(1)(B) must be applied to reduce certain tax attributes of the taxpayer, including, inter alia, any net operating loss or net capital loss for the taxable year of the discharge and any net operating loss carryover or any capital loss carryover to such taxable year. Sec. 108(b)(1) and (2)(A), (D). Respondent contends that in the event we determine that petitioners are entitled to exclude any discharge of indebtedness income, then petitioners must eliminate their claimed tax attributes as follows: A net operating loss of \$163,47533 for 1994; a net operating loss carryover to 1994 of \$238,293; a net short-term capital loss of \$5,849 for 1994; and a long-term capital loss carryover to 1994 of \$8,194.34 We agree and so hold.

Conclusions

This case is a reminder that it's incredibly important to dot the i's and cross the t's on this issue—and that if you do that, you can obtain the results the taxpayer wants. But, as *Ruckriegel* showed, you cannot attempt to fix problems after the fact. In *Miller*, the fact that his tax adviser took control and made sure that all the formalities were properly followed created a much better tax result for Mr. Miller than would have taken place otherwise.

Note that had Mr. Miller not been found to have loan basis, basis never would have been created for him and he never would have been able to deduct the loss. However, in this case he got the losses and then §108 served to protect him from having to pick up the related income.