S Corporation Debt and How To Not End Up With Basis
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S Corporation Debt Revisited

We stay on the same basic issue we talked about last time, except this time we don't look at new revised rules that can get clients into tax hot water, but rather this time at taxpayers that managed to run afoul of rules that had been in place for quite a while. We at the Tax Court's decision in the case of *Russell v. Commissioner*, TC Memo 2008-246, where taxpayers managed to demonstrate multiple ways to be effectively on the hook for debt, but still be unable to use that debt to claim S corporation losses.

S Corporation Debt Basis Rules

The ability to claim a pass through loss from an S corporation depends on having sufficient basis to claim such losses. In §1366(d)(1) we find the general rules for limiting the deduction of losses. The provisions begins by telling us that the loss allowed for a shareholder for a year cannot exceed the sum of two items. The first of these involves the stock of the company held by the shareholder, and the limit there is defined as:

> (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

As noted, we find the general rules for stock basis in §1367(a).

However, unlike a partnership, the basis in the ownership interest is not increased by a taxpayer's share of the debt, even if that is one that is fully recourse as far as the shareholder is concerned. Rather in the S Corporation we look towards debt from the shareholder to the corporation. The definition of that debt is found at §1366(d)(1)(B) which reads:

> (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).

The key issue is that debt must be from S Corporation to the shareholder. And the case law makes it clear that "close" doesn't count for these purposes—so debt guaranteed by the shareholder or debt from another entity the shareholder controls doesn't count.

In today's case we will see two different ways these taxpayers managed to foul up handling the debt to the Corporation that creates a problem for basis.

Variety of Debts

The case involved two couples—the Russells and the Kopsengs, who resided in North Dakota and had interests in a number of entities. The key one of interest in this case is Missouri River Royalty Corp., an S corporation until it terminated its election voluntarily effective September 1, 1997, when its shares were transferred by the above shareholders to United Energy Corporation in a transaction that qualified under IRC §351. Interests in other businesses were also transferred at that time. The Tax Court noted that nothing in the documentation of the §351 discussed assumption of debts to the shareholders as part of this transaction.

There were a number of notes involved in the transaction. The Court deals with the facts surrounding them in order

BNC Notes

Missouri River Royalty Corporation borrowed funds from BNC in the first note in question. The Tax Court outlines the inception of this loan:

> On or about August 16, 1996, BNC National Bank (BNC) lent $1 million to MRRC. MRRC used the proceeds of the loan to pay off certain prior loans that

> had been incurred to purchase and rework oil wells. In consideration for the loan, MRRC gave BNC a promissory note for $1 million (MRRC note) and entered into a loan agreement.

In early 1997 (well before the S election was terminated) the loans were reworked. The revised loans are noted below:

> On January 3, 1997, BNC canceled the MRRC note in consideration for (1) a $463,968 promissory note which Mr. Russell cosigned (the MRRC/DR note), and (2) a $463,968 promissory note which Mr. Kopseng cosigned (the MRRC/LK note). Mr. Russell and Mr. Kopseng also indicated that they intended to guarantee the MRRC/DR note and the MRRC/LK note.
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> The MRRC/DR note and the MRRC/LK note both listed MRRC as the borrower and indicated that they were for the renewal of the MRRC note.

The Court notes that all payments on this loan through the September 1, 1997 effective date of the §351 incorporation transaction were made by MRRC. On September 3, 1997 the balance of the note was paid off by MRRC, and all interest that was due at that time was reported on the consolidated tax return for the newly formed parent corporation.

As well, neither couple reported interest income from MRRC related to this note.

Russell and Kopseng Ledger Debt

The next debt considered is one the Tax Court called the Russell and Kopseng Ledger debt. Mr. Russell's debt is described as follows:

> Before April 5, 1996, Mr. Russell made a series of cash advances to MRRC which MRRC used for working capital (the Russell ledger debt). As of April 5, 1996, the principal balance of these advances totaled $562,705. In MRRC's books, the Russell ledger debt was recorded as a liability in a ledger account entitled "Notes Payable Russell" (the notes payable Russell account).
>
> On April 5, 1996, MRRC issued a $562,705 note to Mr. Russell for the Russell ledger debt (the Russell ledger debt note). As of September 1, 1997, the principal balance of the Russell ledger debt was $65,527.

A similar loan account existed for Mr. Kopseng as noted below:

> Before April 5, 1996, Mr. Kopseng made a series of cash advances to MRRC which MRRC used for working capital (the Kopseng ledger debt). As of April 5, 1996, the principal balance of these advances totaled $611,144. In MRRC's

> books, the Kopseng ledger debt was recorded as a liability in a ledger account entitled "Notes Payable Kopseng" (the notes payable Kopseng account).
>
> On April 5, 1996, MRRC issued a $611,144 note to Mr. Kopseng for the Kopseng ledger debt (the Kopseng ledger debt note). As of September 1, 1997, the principal balance of the Kopseng ledger debt was $117,438.d

The Court then goes on to describe these notes in more detail:

> The Russell ledger debt and the Kopseng ledger debt were demand obligations. Interest on the Russell ledger debt and the Kopseng ledger debt was calculated using monthly compounding. There was no requirement that interest accruing on the Russell ledger debt and Kopseng ledger debt be paid at least annually.

REMC Note

Rainbow Energy Marketing Corporation was another entity owned by Mrs. Russell and Kopseng, shares of which were eventually transferred to United Energy Corporation in the §351 transaction. This entity was also involved in loaning money to MRRC. The Court begins by noting:

> REMC lent MRRC $57,000 on April 1, 1996, and $37,000 on April 11, 1996 (REMC ledger debt). MRRC used the REMC ledger debt for working capital. In MRRC's books, the REMC ledger debt was recorded as a liability in a ledger account entitled "Notes Payable Kopseng/Russell Partnership." The REMC ledger debt was a demand obligation. There was no requirement that interest accruing on the REMC ledger debt be paid at least annually.
>
> A note was prepared in connection with the REMC ledger debt (the REMC note). The REMC note stated, in part, that "Effective April 1, 1996, Missouri River Royalty Corporation promises to pay Kopseng/Russell Partnership $94,000.00 at an interest rate of the applicable Federal Rate Table." Interest on the REMC ledger debt was in fact calculated at a rate that varied from the Wall Street Journal Prime Rate plus 1 percent to the Wall Street Journal Prime Rate plus 2 percent. Interest on the REMC ledger debt was calculated using monthly compounding. At all times, the rates used to calculate interest on the REMC ledger debt exceeded the short-term, monthly-compounding Applicable Federal Rate as then in effect. There was no requirement that interest accruing on the REMC ledger debt be paid at least annually.

Following the effective date of the S termination, the following entries were made on

REMC's books:

> On June 30, 1998, an adjusting journal entry to MRRC's books reclassified $22,042 of the $75,750 balance of the REMC ledger debt to the notes payable Russell account and $53,708 of the balance to the notes payable Kopseng account. The adjusting journal entry allocated the balance of the REMC ledger debt between the notes payable Russell account and the notes payable Kopseng account in proportion to the interests held by Mr. Russell and Mr. Kopseng in REMC at the time the loans were made in April of 1996.

Short Term Debt from RGC Partnership

Finally there's a debt referred to as "the Short-Term Debt" by the Court, a debt that was received from and paid to Rainbow Gas Company, a Partnership that was also owned by Mr. Russell and Kopseng. That partnership also became part of the September 1, 1997 Section 351 transaction.

The Court noted:

> The loans making up the short-term debt were transferred directly from the checking account of RGC Partnership to the checking account of MRRC. The repayments were transferred directly from the checking account of MRRC to the checking account of RGC Partnership. Before August 31, 1997, the short term debt was recorded in MRRC's books as a liability in a ledger account entitled "Notes Payable RGC". As of August 31, 1997, an adjusting journal entry to MRRC's books reclassified $569,298 of the short-term debt to the notes payable Kopseng account and $569,298 to the notes payable Russell account.

It's probably not coincidental that the journal entry is dated the day before the S election terminated.

The Court goes on to describe the note documents:

> With respect to each of the nine loans comprising the shortterm debt, four notes were prepared: (1) One from Mr. Russell to RGC Partnership (Russell/RGC notes), (2) one from Mr. Kopseng to RGC Partnership (Kopseng/RGC notes), (3) one from MRRC to Mr. Russell (MRRC/Russell notes), and (4) one from MRRC to Mr. Kopseng (MRRC/Kopseng notes). The face amount of each note was half of the amount transferred from RGC Partnership to MRRC on the date of the respective transfer.

After giving the noted balances, the Court goes on to describe the terms of the note:

> Each of the short-term notes bore an "effective" date which was identical to the

> date on which the corresponding loan was made to MMRC. Both Mr. Kopseng and Mr. Russell signed each of the short-term notes, either in their individual capacities or on behalf of RGC or MMRC, but none of their signatures were dated. The short-term debt was a demand obligation.
>
> Each short-term note stated that it bore interest at "an interest rate of the applicable Federal Rate Table." However, interest on the short-term debt was calculated at a rate that varied from the Wall Street Journal Prime Rate plus 1 percent to the Wall Street Journal Prime Rate plus 2 percent. Interest on the short-term debt was calculated using monthly compounding. At all times, the rates used to calculate interest on the short-term debt exceeded the short-term, monthly-compounding Applicable Federal Rate as then in effect. There was no requirement that interest accruing on the short-term debt be paid at least annually.

The payment record is described further by the Court:

> On September 3, 1997, the $1,138,597 principal balance of the short-term debt, along with accrued interest thereon of $62,578, was paid by using a $1,201,175 cashier's check from MRRC to RGC. The $1,201,175 payment was reflected in MRRC's books by (1) debiting the notes payable Russell account for $569,298, (2) debiting the notes payable Kopseng account for $569,298, and (3) debiting the loan interest account for $62,578 with the memo notation "Interest paid to Kopseng & Russell for Note." The $1,201,175 payment was reflected in RGC's books by (1) crediting the "Notes Payable Don Russell" ledger account for $569,298, (2) crediting the "Notes Payable Loren Kopseng" ledger account for $569,298, and (3) crediting the interest income account for $62,578 with the memo notation "Interest on Note Rec. from MRRC."
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> The $62,578 of accrued interest on the short-term debt was reported on the 1998 UEC Form 1120 as an interest expense of MRRC and interest income of RGC. None of the $62,578 was reported on Mr. Russell's 1997 Form 1040 or Mr. Kopseng's 1997 Form 1040, either as interest income or interest expense.

Obviously, the key issue comes down to whether or not the taxpayers have basis in all of these notes, having exhausted their stock basis (and thus the reason why we have the issue before the Court). Unfortunately for the taxpayer, in three of four cases the Court and the IRS found that no basis existed for the shareholders.

The Problem With the Debts

The Court outlines, based on prior cases, a number of factors that need to exist for a shareholder to make use of debt basis. These are

- "First, a shareholder must make an actual economic outlay." and that means, per the court that "The economic outlay must leave the taxpayer 'poorer in a material sense' in order for its bona fides to be respected.
- "Second, the S corporation's indebtedness must run directly to the shareholder" Specifically the Court observes that an advance from a related passthrough entity will not be sufficient, nor any other "indirect" borrowing including, the court notes, "a guaranty,surety, accommodation, comaking or otherwise" indirectly making the loan
- Indirect loans will only count at such time as the shareholder actually makes an advance against the loan—prior to that time it's only a "potential" debt from the corporation rather than actual one.

As you can probably figure out, Mr. Russell and Mr. Kopseng ended up with some real problems with these issues.

For the MRRC/DR Note and the MRRC/LK Note the problem is that all that happened was that that shareholders guaranteed and were cosigners with the corporation—but the corporation actually made all of the payments. As is noted above, only if the shareholders actually made payments on the loans would there have been a debt from the corporation to the shareholders. At the balance sheet date, the corporation's direct debt was to BNC and the corporation would only have a liability to the shareholders if it failed to make the payments.

The REMC ledger debt was a different problem—it was a C corporation owned by the shareholders. The Court quickly dismisses the journal entry (a favorite technique of outside CPAs trying to do after the fact triage on such messes) by noting:

> Although the REMC ledger debt was eventually reclassified in MRRC's books on June 30, 1998, as notes payable to Mr. Russell and Mr. Kopseng, the record is devoid of any evidence suggesting that this treatment was intended at the time REMC made the loans. Standing by itself, this adjustment of a journal entry several years after the actual transaction is insufficient to reclassify the source of a loan.

Thus, even with this after the fact journal entry there still was no basis—the journal entry standing alone doesn't show the intent at the time the debt was entered into, and that is the crucial factor here.

On the partnership loan, the IRS and taxpayers took different views. The Court noted:

> Respondent contends that the short-term debt should be classified as a direct loan from RGC Partnership to MRRC. Petitioners contend that the short-term debt constituted a series of back-to-back loans from RGC Partnership to Mr. Russell and Mr. Kopseng and from Mr. Russell and Mr. Kopseng to MRRC.

The Court sides with the IRS view that this was a debt from the partnership to the S Corporation, and it would not treat as "bouncing" through the owners. The Court notes:

> The only evidence in the record supporting petitioners' characterization consists of (1) the short-term notes themselves and (2) the August 31, 1997, adjusting journal entry to MRRC's books reclassifying the short-term debt. The four short-term notes have little probative value as nothing in the record indicates that they were executed contemporaneously with the nine advances to MRRC. Although each short-term note bears an effective date which is identical to the date on which RGC Partnership made a corresponding advance to MRRC, Mr. Russell's and Mr. Kopseng's signatures on the notes are not themselves dated, and petitioners failed to present evidence indicating when the notes were executed.
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> Petitioners' reclassification of the short-term debt on MRRC's books is insufficient by itself to prove the loans' origin. The reclassification occurred on the last day of MRRC's final taxable year and only one day before the section 351 transaction. Petitioners offered no explanation for the timing of the reclassification. Not being contemporaneous with the actual advances, the adjusting journal entry cannot establish that the short-term debt constituted back-to-back loans at the time the advances were made.,

As well the court takes note of the reporting of the interest—and that it did not end up on the individual returns:

> Finally, none of the interest paid on the short-term debt was included in gross income or deducted as an expense by Mr. Russell or Mr. Kopseng. For these reasons, the short-term debt is best characterized as a series of loans from RGC Partnership to MRRC. The issuance of the short-term debt did not constitute an economic outlay by MRRC's shareholders, and did not create basis in MRRC stock.

Only the informal open account debt was granted basis—and, in that case, the IRS conceded that it granted basis.

> Respondent concedes that the Russell ledger debt and the Kopseng ledger debt constituted indebtedness of MRRC to Mr. Russell and Mr. Kopseng for purposes of section 1366(d)(1)(B).

Lessons

An important lesson from this is that clients need to understand that S corporation debt involves some very strict "bright line" rules that don't appear to go along with economic reality—but they must be respected. As well, it should be clear that "after the fact" clean

up by the CPA via journal entries aren't going to carry weight unless there is other evidence that the original recording was in error—and if the only evidence is that the taxpayers, after learning the consequences of their actions, now claim they "really" meant something else isn't going to carry much weight (Tax Courts judges tend to remark about "self-serving testimony" in such cases).

As well, CPAs need to be very careful if they decide to go the journal entry route. First, even if there is an argument to be made based on evidence of the taxpayer's intent, it's too easy for a client to conclude it's "no big deal" when the CPA "fixes" things at year end, thus continuing the problem year after year. In that case, the client may justifiably be upset if losses get disallowed on examination, wondering why they weren't told—though most often it's because the CPA has concluded there would be resistance from the client to changing their methods.

Second, CPAs need to be mindful of the responsibilities imposed by Circular 230, §6694 and the *Statements on Standards for Tax Services* for tax return positions. A CPA could find it very difficult to explain the authority behind the journal entry when there appears to be no independent evidence supporting the journal entry as reflecting what actually happened and that the actual recording was clearly erroneous.