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Court Addresses Limitations on Pass-Through of Services

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A loss incurred by an "S corporation" can be "passed through" to, and deducted by, its shareholders, but only to the extent of the shareholders' bases in their stock of the corporation and in indebtedness of the corporation owed to them (the "basis limitation" of IRC § 1366(d)(1)). The at-risk rules of IRC § 465 further limit an individual's deduction of losses from an activity (whether conducted directly by the individual or through a "pass-through entity," such as an S corporation) to the individual's "amount at risk" with respect to the activity.

In *Miller v. Commissioner* (T. C. Memo 2006-125, June 15, 2006), involving a shareholder who initially guaranteed corporate borrowings from a bank and then replaced those borrowings with "back-to-back" borrowings by the shareholder from the bank and by the corporation from the shareholder, the Tax Court addressed these limitations on the pass-through of losses. The decision also addressed whether, when the corporation became insolvent during the years at issue and part of the bank debt incurred by the shareholder was paid by guarantors (other shareholders), that payment resulted in cancellation of debt ("COD") to the borrowing shareholder excludable from gross income by reason of that shareholder's insolvency.

Facts in 'Miller'

In 1988, Timothy Miller ("Miller") incorporated Miller Medical Systems, Inc. ("MMS"), an S corporation in the business of manufacturing medical diagnostic facilities, as MMS's sole shareholder.

The business operations of MMS were financed through loans to the corporation from Huntington National Bank ("Huntington"), and MMS incurred annual net operating losses from its inception through 1994.

In February 1992, four individual investors contributed $800,000 in the aggregate to MMS in exchange for 15% of its common stock. Shortly thereafter, MMS obtained a $1,000,000 revolving line of credit from Huntington, secured by: security interests in the property of MMS; a guaranty by Miller, secured by a second mortgage on his home; and guarantees by each of the investors of specified portions of the line of credit. The investors' guarantees were collectively equal to the maximum authorized indebtedness under the line of credit and secured by a pledge of stock in an unrelated corporation.

By late 1992, it was apparent that MMS would have a net operating loss for 1992, and that Miller would be precluded from claiming his share of this loss, as he had been precluded from claiming MMS's losses for 1990 and 1991, by the basis limitation of § 1366(d)(1). In order to mitigate the effect of that limitation, the Huntington line of credit was restructured, on December 30, 1992, as a line of credit to Miller personally (the "Miller/ Huntington loan"), with an initial draw of $750,000. That amount was immediately lent by Miller to MMS (the "MMS/Miller loan") and used by MMS on the same day to pay off its borrowing from Huntington.

Miller pledged his note from MMS as additional security for his obligation to Huntington. Both the Miller/Huntington and MMS/Miller loans matured in one year and carried the same interest rate as the former loan by Huntington to MMS.

Over the following two years, the amounts borrowed under the loan arrangements increased in stages to more than $1,000,000, and additional security was ultimately provided in the form of a second mortgage on Miller's parents' personal residence and an agreement that the market value of the collateral securing the Miller/Huntington loan must at all times be at least 1/3 greater than the authorized credit line.

In December 1994, when there was an outstanding principal balance of $1,375,000 under the Miller/Huntington loan, MMS became insolvent. To resolve their obligations under the guarantees, the investors: (i) paid $900,000 to Huntington, thus reducing the balance of the Miller/Huntington loan to $475,000; (ii) borrowed personally from Huntington to purchase the Miller/Huntington loan note for the reduced principal amount; (iii) formed a new LLC to purchase the remaining assets of

MMS and perform MMC's remaining contracts; and (iv) used the proceeds from the performance of those contracts to repay their personal loans from Huntington.

Under the basis limitation, a shareholder's basis in debt of the corporation increases the amount of corporate losses that may be passed through to the shareholder. The intended effect of the 1992 debt restructuring was to provide Miller with substantial basis in debt of MMS that could be taken into account for these purposes. Accordingly, Miller's tax returns for 1992, 1993, and 1994 reflected substantial losses from MMS that became available to Miller by reason of the restructuring of the former corporate loan from Huntington as loans from Huntington to Miller and from Miller to MMS. The IRS, however, asserted that Miller was not entitled to any basis by reason of the Huntington indebtedness, viewing the Huntington loan as remaining indebtedness of the corporation, with Miller acting as, at best, an accommodation surety. The IRS also argued that Miller was not "at risk" for the amounts borrowed from Huntington and that any losses that did pass through to him should therefore be limited by the at-risk rules. Finally, the IRS asserted that, if the losses from MMS were allowed to Miller, he should be required to include $1,350,000 of COD income in 1994, by reason of repayment of the Huntington debt by the investors.

Discussion

Basis Limitation. The Tax Court opinion first concludes that the "back-to-back" financing arrangement resulted in Miller's holding indebtedness of MMS, notwithstanding that it was part of an arrangement that replaced prior debt not includible in Miller's basis. The court noted, in particular, that: Miller provided his own, fully recourse promissory note; further advances were made after the note restructuring, from Huntington to Miller and from Miller to MMS, consistent with the loan arrangement as restructured in 1992; and the indebtedness was fully documented and involved an unrelated third party (Huntington) that could be expected to pursue Miller for repayment, if necessary.

Even the requirement of Huntington that the funds lent to Miller be used only to advance funds to MMS was not inconsistent with Miller's position that he had borrowed funds from Huntington and lent them to MMS. Further, the fact that Huntington required an assignment of the MMS/Miller loan note to Huntington as further collateral for Miller's borrowing did not establish that MMS remained, in substance, the borrower from Huntington, since the security agreement clearly described the assignment as a collateral assignment of a security interest, rather than a sale.

The court was unpersuaded by what was perhaps the strongest argument of the IRS, that the circumstances that suggested that MMS and perhaps the investors, but not Miller, were the expected sources of repayment of the indebtedness. The opinion notes that Miller was required to provide a second mortgage on his home, to enter into certain covenants in favor of the bank, and ultimately to provide a second mortgage secured by his parents' home, in order to obtain the initial and subsequent advances, all of which indicated that Miller should be viewed as the borrower.

At-risk limitation. The "at-risk rules" limit a taxpayer's deductible losses from an activity to the taxpayer's amount at risk with respect to the activity. Although a taxpayer is generally at risk for borrowed amounts for the repayment of which the taxpayer is personally liable, a taxpayer is not considered to be at risk with respect to amounts with respect to which he is "protected against loss" through guarantees, stop-loss agreements, or similar arrangements.

The IRS argued that the guarantees provided by the investors to the bank; the fact that petitioner's net worth at the time MMS became insolvent was relatively modest (about $273,000) and attributable to relatively illiquid personal assets; and the investors' prior execution of waivers of any right to recover from Miller in the event the investors were required to pay the Huntington debt under their guarantees, removed any realistic possibility of Miller's having to repay the debt from other funds if and to the extent MMS proved incapable of repaying its debt to Miller, thus protecting Miller against loss and making the Miller/Huntington debt not an amount at risk.

The court states that the relevant standard was whether Miller "faced any realistic possibility of an economic loss" and concluded that he did, noting the possibility that Huntington might have proceeded against him (rather than the guarantors) for repayment if, for example, his financial circumstances had been stronger at the time of MMS's insolvency.

COD. The IRS also asserted that Miller had COD income of $900,000 in 1994, because that portion of the Miller/Huntington loan was paid down by the investors in that year. Miller asserted that no discharge of his debt had occurred, because he remained liable to the investors for the amounts they paid as guarantors. Miller offered no evidence of his continuing liability, however, other than his "self-serving testimony," which appeared at odds with the investors' waivers of any right of indemnification, reimbursement, or subrogation that would otherwise arise from payment by them under their guarantees.

The opinion also notes that, in the period of more than eight years from the time of payment to the trial of the Tax Court case, the investors had not sought reimbursement from Miller and Miller had not made any payment in satisfaction of his alleged liability to them. "The existence of a faint possibility that a debt will be collected" did not prevent the recognition of COD income, and Miller had failed to establish that his debt had not been discharged.

The opinion then addresses whether the amount of the Huntington debt was includible as a "liability" in Miller's debts in determining whether he was "insolvent" at the time the debt was discharged. If it was, his liabilities would exceed his assets by more than

the amount of debt discharged, and that amount would therefore be entirely excluded from his taxable income under the "insolvency exclusion" of IRC §108(a)(1)(B), although Miller would have to reduce certain of his loss carryovers and other "tax attributes."

The IRS argued that the Huntington debt should not be taken into account in determining insolvency, because the liability was unlikely to be paid by Miller in light of the investor guarantees and their waiver of certain rights against Miller. The opinion had concluded, however, that the Huntington debt was a bona fide liability of Miller for purposes of the basis limitation and computation of the amount of Miller's COD income, and noted that to exclude such a debt from the insolvency computation merely because it was ultimately discharged without payment would be inconsistent with the intent and terms of IRC § 108, under which the insolvency of a taxpayer is to be determined on the basis of the taxpayer's assets and liabilities "immediately before the discharge" (IRC § 108(d)(3)).

Accordingly, the $1,375,000 amount of the Huntington debt was counted as a liability of Miller, Miller was determined to be insolvent by an amount greater than the debt discharged in 1994 ($900,000), and the entire amount of the discharge was excluded from income. However, in accordance with the provisions of the section 108 exclusion of COD from income, certain of Miller's tax attributes, including his net operating loss carryovers and short- and long-term capital losses, had to be reduced to the extent of the amount of the discharge or (if less, as was the case here) the amount of such attributes available for reduction.

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