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Loss Disallowance for S Corp. Shareholders: "Broz"

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The rule that limits the losses of an S corporation that may be taken into account by a shareholder to the sum of (i) the adjusted basis of the shareholder in stock of the corporation and (ii) the shareholder's adjusted basis in any indebtedness of the corporation to the shareholder is significantly more stringent than the equivalent rule for partnerships and has long been a troublesome trap for S corporations and their shareholders.[1] Debt obligations of the corporation to persons who are not shareholders do not increase the loss limitation, even if the debt arose from a borrowing from another entity owned by shareholders of the S corporation or is guaranteed by those shareholders. Thus, the allowability of pass-through losses to a shareholder of an S corporation will in many instances turn on whether the activities of the corporation were funded through (x) capital contributions or loans from the shareholder or (y) loans to the corporation from anyone else.

As a case on point, the Tax Court held two years ago, in *Broz v. Commissioner*,[2] that amounts borrowed by an S corporation that were attributable to a bank loan made to another corporation under common control could not be taken into account by the S corporation shareholder in determining his basis for these purposes, even though book entries had been made and loan documents executed, after the funds were advanced, to categorize the loans as having been made from the affiliated corporation to the common shareholder and by that shareholder to the corporation incurring the losses. The Tax Court also disallowed numerous deductions by reason of a failure to establish the existence of a relevant "active trade or business." The recent affirmance of *Broz* by the Court of Appeals for the Sixth Circuit is discussed below.

Facts in "Broz"

Robert Broz (Broz) formed RFB Cellular, Inc. (RFB) as an S corporation in 1991 to invest in the development of cellular phone networks in rural areas. He contributed a FCC license to operate a cellular network in Northern Michigan to RFB in exchange for its stock, and RFB provided cellular phone service thereafter with that license and an additional license purchased by RFB in 1996.

Broz organized another S corporation, Alpine, the stock of which was owned 99% by him and 1% by his brother, to bid on other cellular phone licenses. With respect to 12 bids that were successful, Alpine acquired licenses from the FCC through cash down payments and notes for the balances due, and then transferred most of the licenses to limited liability companies owned by him and his brother in the same 99:1 proportion (the license holding companies). The license holding companies were formed to hold the licenses and lease them to Alpine, but apparently no such leases were entered into.

Licenses held by Alpine and the license holding companies were used by RFB to provide digital service in areas already covered by RFB's licenses. Alpine and the license holding companies did not provide phone services and had no income other than amounts allocated to them by RFB attributable to RFB's use of the licenses. However, Alpine claimed interest deductions on debt owed to the FCC and RFB (further discussed below) attributable to the acquisition of the licenses (though no interest was paid by Alpine) and depreciation and other deductions, and the license holding companies claimed deductions for interest on related party borrowings to service the FCC debt and amortization deductions related to the acquisition of the licenses.

The bank that was the main commercial lender to RFB lent funds to RFB with the understanding that loan proceeds would be used to expand the cellular business through Alpine and related entities. The bank loan was an obligation of RFB secured by a pledge by Broz of his RFB stock and by assets of the license holding companies; also, some of the license holding companies guaranteed the bank loans.

The amounts so advanced to Alpine and the license holding companies were initially booked on the ledgers of RFB,

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Alpine, and the license holding companies as advances by RFB to Alpine, and as advances or notes payable by Alpine to the license holding companies. Year-end book entries were made to reclassify the advances as loans from RFB to Broz and from Broz to Alpine or the license holding companies, and promissory notes were subsequently delivered by Alpine to Broz and by Broz to RFB to reflect unpaid interest on the loans. In 1999, the loans from RFB were reclassified through year-end entries as loans from Alpine Investments, a single member limited liability company formed and owned by Broz to serve as an intermediary for the loans, and Alpine Investments executed notes to RFB to document the loans. By 2002, however, Alpine and the license holding entities had ceased all business activities.

The IRS determined deficiencies of more than $16 million against Broz for the tax years at issue (1996, and 1998 through 2001) and Broz filed a petition for review in the Tax Court. The deficiencies reflected government determinations that, among other things, Broz lacked basis in Alpine sufficient to claim losses from flow-through deductions and that Alpine and the license holding companies could not deduct interest and amortization deductions because they were not engaged in an active trade or business. The Tax Court resolved these issues (and others) against Broz.

Decision by Court of Appeals

On appeal, the Sixth Circuit agreed with the Tax Court that there were no bona fide loans from Broz to Alpine with respect to the funds borrowed from the bank for use in the license holding activities. Neither the Tax Court nor the Court of Appeals disagreed with Broz's contention that, if funds had in fact been borrowed by Broz and then lent by him to Alpine through back-to-back loans, he would have had the requisite debt basis to support the flow-through of deductions to himself as a shareholder/creditor of Alpine.

The courts concluded, however, that this is not what in fact occurred; rather, funds were lent by the bank to RFB and by RFB to Alpine. This characterization of the relationships between the parties appeared more consistent with the book entries made at the times funds were advanced. Also, the courts observed that the fact that Broz signed the notes evidencing the affiliated party debt on behalf of the various entities made it unlikely that any of the entities would seek to enforce the notes against him, and concluded that the notes were not genuine indebtedness.[3]

For a shareholder to have basis in S corporation obligations to support the flow-through of deductions, cases have stated that the shareholder must also show that an economic outlay was made by the shareholder to acquire the indebtedness—for example, through the advance of funds by him.[4] Broz could not show that, but argued that the pledge of his RFB stock as collateral for the bank loans constituted such an outlay. The courts declined to accept that argument, because Broz himself did not make payments on those loans and did not otherwise incur any direct detriment or cost by reason of the pledge.[5]

The second issue addressed in the Court of Appeals decision related to whether the deductions for various interest and other expenses that were claimed by Alpine, and the amortization deductions relating to the FCC licenses claimed by the license holding companies, were not deductible because the interest and other expenses claimed by Alpine were not incurred "in carrying on a trade or business," as required to claim a deduction under Internal Revenue Code (IRC) section 162(a), and because the amortization deductions did not relate to property "held in connection with the conduct of a trade or business" within the meaning of IRC section 197(c)(1).[6]

Both the Tax Court and the Court of Appeals opinions characterize the issue in some places as whether the relevant entity was engaged in an "active trade or business," but neither of the Code provisions at issue contain a requirement that there be an "active" business. In any event, the Tax Court had concluded that the costs Alpine incurred were in the nature of start-up costs (and therefore required to be capitalized) because Alpine never functioned as a going concern. The Tax Court found Broz's claim that Alpine had two on-line networks to be unsupported by the evidence, which indicated that the only network operations under Broz's control were operated by RFB.

It was also noted that, in the case of each of three FCC licenses not assigned by Alpine to other entities, Alpine failed to meet the FCC build-out requirements, such that all three licenses were canceled by the FCC or returned by Alpine to the FCC; and that Alpine had not elected to amortize startup expenses under IRC section 195 by attaching a statement to its tax return and therefore was not entitled to any deduction under that provision.

The courts also declined to accept Broz's argument that the expenses should be viewed as incurred in connection with an expansion of an existing trade or business of RFB, and deductible as such without regard to whether Alpine itself was engaged in a trade or business, with the Tax Court asserting that each "entity's activity must be evaluated individually and not in conjunction with any other entity."[7]

Finally, it was determined that (notwithstanding Broz's assertion to the contrary) no amortization deduction could be claimed under section 197 before the time the property acquired was used, or otherwise held in connection with the conduct of a trade or business. Therefore, the Tax Court determined, and the Court of Appeals agreed that the deductions claimed by the license holding companies were not allowable because, although those entities were formed to acquire and lease FCC licenses, they never actually leased the licenses for that use (or presumably any other use) in the years at issue.

Given the conclusions described above, the Court of Appeals found it unnecessary to address a further issue, discussed in the Tax Court decision, regarding whether the pass-through of losses sought by Broz was also precluded by the at-risk rules of IRC section 465.

Proposed Regulations

Amendments to regulations under IRC section 1366 were proposed last year to address the S corporation shareholder basis issue with respect to shareholder loans.[8] Those regulations are generally consistent with the rules developed by case law as described above. The amendments would confirm that a shareholder guarantee will generally not provide the shareholder with basis unless or until payments are made with respect to the guarantee. The regulations as amended would further provide that shareholder debt will be recognized for shareholder basis purposes if it represents "bona fide indebtedness" of the corporation to the shareholder under general Federal tax principles.

The preamble to the proposed regulations states that, if a debt constitutes bona fide indebtedness of the corporation to a shareholder, the shareholder need not otherwise satisfy the "actual economic outlay" doctrine (discussed above). This might be viewed as a change in law, and as a favorable development in light of the difficulties in applying this doctrine.

Observations

There are intimations that Broz was perceived by the courts as taking positions that lacked credibility and as seeking large deductions on the basis of relatively scanty business activity financed virtually entirely with borrowed money. These circumstances may have caused certain issues to have been decided against him that a more sympathetic court might have resolved differently. The case also underscores, however, the importance of appropriate advance planning, taking into account business and tax considerations, for organizing and funding the formation and expansion of a business, and then of implementation of the plan through appropriate and timely documentation consistent with arm's length dealings.

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1 IRC § 1366(d). By contrast, although a partner's distributive share of partnership loss is not allowed to the extent it exceeds the adjusted basis of that partner's interest in the partnership, that basis generally includes the partner's share of liabilities of the partnership attributable to borrowings from third parties. IRC §§ 704, 752(a).

2 *Broz v. Commissioner*, 137 T.C. 46 (2011), affirmed, 112 AFTR 2d 2013-5823 (6th Cir.). The Tax Court decision was discussed in Pisem and Zhang, *The Wizard of Broz: S Corporations, Economic Outlay, and Debt Basis*, 116 J. Taxation 79 (Feb. 2012).

3 The authors of this article express no view as to whether commercial law supports the courts' views as to the significance of who signed the notes, in respect of the enforceability of the notes. However, these courts are certainly not the first to express doubts as to whether loan instruments between entities under virtually identical ownership will be enforced.

4 *See Oren v. Commissioner*, 93 AFTR 2d 2004-858 (8th Cir.), and authority cited therein; *see also* the discussion in Pisem and Zhang, *supra* note 3. *But see* the preamble to proposed regulations (REG-134042-07, June 12, 2012) to amend Reg. § 1.1366-2 (discussed below).

5 Broz also argued that RFB should be considered as having made its payments to Alpine on his behalf as his "incorporated pocketbook", but the Tax Court concluded that Broz failed to establish that RFB habitually or routinely paid expenses of Broz on Broz's behalf, and the Court of Appeals did not disagree.

6 So far as appears from the opinions, Broz did not assert, and the courts did not consider whether, even if Alpine and the license holding companies were not engaged in any trade or business, some of these expenses should have been deductible under IRC § 212 as incurred for the production of income or to manage or conserve property held for the production of income—but conceivably these were not tenable positions with respect to the nature of the FCC licenses involved, or would not have helped the taxpayer in light of the myriad limitations on § 212 deductions.

7 It is not apparent that Broz attempted to argue that he was engaged in these businesses in his individual capacity. In this respect, the fact that the principal business activities were conducted through RFB, a corporation, rather than through a partnership or entity classified as a partnership for tax purposes, may have been unhelpful. *Compare* IRC § 875 (treating foreign partners as engaged in any trade or business in which the partnership is engaged).

8 Fed. Reg. Vol. 77, No. 113, p. 34884 (REG-134042-07, June 12, 2012).