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# The Wizard of Broz: S Corporations, Economic Outlay, and Debt Basis

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The Tax Court's recent decision in *Broz*, 137 TC 46 (2011), relied on the mystical force of the repeated invocation of the mantra of "economic outlay" to disallow deductions under circumstances that were in many ways indistinguishable from those in cases in which similar deductions were allowed.

The Service's examination of the income tax returns of Robert and Kimberly Broz resulted in asserted deficiencies of more than $16 million for 1996 and 1998-2001. These asserted deficiencies arose primarily from the Robert Broz's investment in the cellular phone industry, and they involved a wide variety of Code provisions.[1] This article focuses on issues relating to the allowability of Broz's 99% share of the losses of an S corporation.

In an S corporation, of course, each shareholder's pro rata share of the corporation's items of income, loss, deduction, and credit is taken into account in determining the shareholder's income tax liability.[2] The aggregate amount of losses and deductions taken into account by a shareholder, however, cannot exceed the sum of the adjusted basis of the shareholder's stock in the S corporation and the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder.[3]

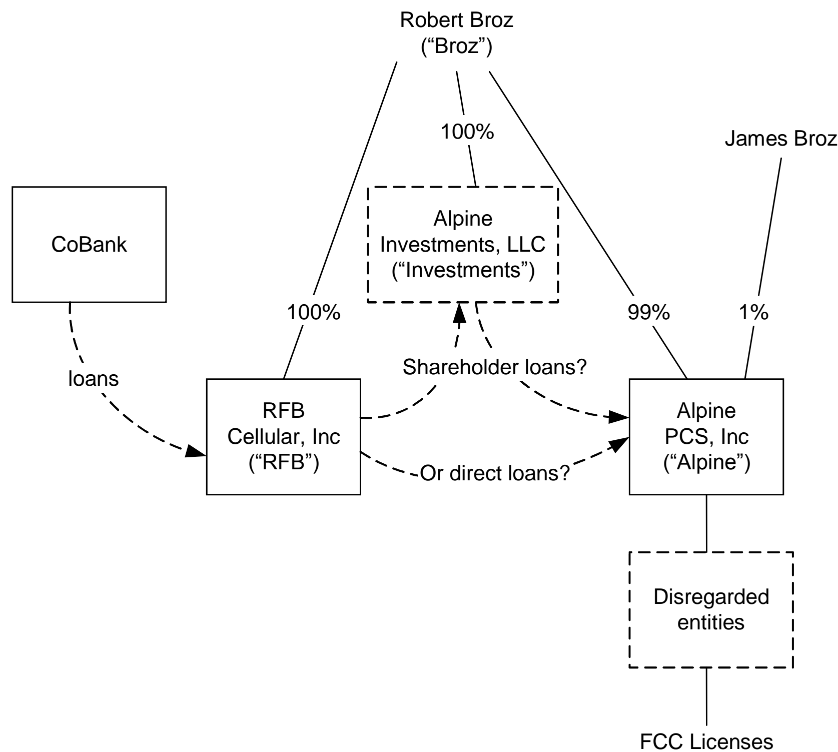
It is well-established that, for purposes of the latter portion of this basis limitation rule (relating to "debt basis"), a shareholder may take into account only indebtedness owed by the S corporation to the shareholder. Thus, for example, the basis of indebtedness owed by the S corporation to another corporation owned by the shareholder, or indebtedness of the S corporation owed to a third party and guaranteed by the shareholder, does not count in determining the limitation on the allowability of S corporation losses to the shareholder. Indeed, the ability to deduct losses has been denied by the Tax Court and by some courts of appeals even in cases in which, under general income tax principles,[4] a loan that was in form made from a third party to the S corporation would properly be recharacterized as a loan from the third party to the shareholder followed by a capital contribution by the shareholder to the S corporation.[5]

Even if a shareholder were to overcome the S corporation basis limitation, the shareholder's S corporation losses may still be disallowed under the at-risk rules. These rules permit an individual to deduct losses from an activity only to the extent of the aggregate amount with respect to which the taxpayer is at risk.[6] A taxpayer may be considered at risk for amounts

borrowed by the taxpayer with respect to an activity,[7] but only if the taxpayer is personally liable for the repayment of those amounts or the taxpayer has pledged property, "other than property used in such activity," as security for repayment.[8] A taxpayer is not considered at risk with respect to amounts that are "protected against loss."[9]

## Entity Structure and Parties' Contentions

For our purposes, the facts set out in great (and sometimes confusing) detail in *Broz* can be illustrated by the diagram in Exhibit 1. The salient elements are as follows:




1) Broz owned 99% of the stock of Alpine PCS, Inc., ("Alpine"), an S corporation. The deductibility of Broz's 99% share of the losses of Alpine was in issue in this case. Alpine conducted some of its operations through wholly-owned entities that were disregarded as separate from Alpine for federal income tax purposes.

2) Broz owned 100% of the interests in Alpine Investments, LLC ("Investments"). Investments was disregarded as separate from Broz for federal income tax purposes, but Broz did not have personal liability for the obligations of Investments.

3) Broz owned 100% of the stock of RFB Cellular, Inc. ("RFB"), an S corporation.

4) Alpine acquired from the FCC licenses to operate cellular service in Michigan. Alpine paid approximately $5 million of cash to the FCC at the time that the licenses were

granted and gave the FCC a note obligating Alpine to pay approximately an additional $41 million over time.

5) RFB borrowed money from CoBank, a third-party institutional lender unrelated to Broz.

6) The funds that RFB borrowed from CoBank were remitted to Alpine by means of transactions described in greater detail below.

7) Broz contended that the remittances from RFB to Alpine should be characterized for Federal income tax purposes as "back-to-back loans," first, from RFB to Broz (or to Investments, an entity disregarded as separate from Broz) and then, from Broz (acting directly or through the disregarded entity, Investments) to Alpine. Broz contended that these loans gave him debt basis in Alpine and increased his amount at risk in Alpine's activities.

8) The IRS took the position that the remittances should be treated as having been made by RFB directly to Alpine, with the effect that they could not increase Broz's debt basis in Alpine. The Service also argued that Broz had not made the "economic outlay" necessary for him to be allowed to increase his basis in the Alpine stock or debt. Finally, the IRS contended that Broz was not at risk with respect to the amounts that had originated with CoBank and had found their way to Alpine, so that any losses that did overcome the basis limitation should be disallowed nevertheless.[10]

## Flow of Funds: Cash, Notes, and Journal Entries

The funds that RFB borrowed from CoBank were remitted to Alpine over several years. When RFB advanced funds to Alpine in 1995 and 1996, the advances were recorded on RFB's books as "other assets."[11] RFB charged the 1997 advances to Alpine on RFB's general ledger as "advances to Alpine PCS," while Alpine recorded the advances on its general ledger as "notes payable Alpine PCS -- RFB Cellular."[12]

The loan arrangement was revised in late 1997 in order for Broz, personally, to be the lender to Alpine. According to the Tax Court petition, the "restructured loan arrangement was the direct result of careful tax planning by well respected tax advisors consistent with existing statutory tax laws as interpreted by case law and IRS rulings."[13] To implement the restructuring, Broz executed an Assignment and Release Agreement on 12/11/97, to assume formally the amounts that Alpine owed to RFB; the agreement obligated Alpine to pay Broz the same amount.[14] On 12/31/97, RFB reclassified the Alpine advances on its general ledger as loans to its shareholder, Broz.[15] Likewise, Alpine on the same day made an adjusting entry to its ledger to reclassify the advances received from RFB as a loan from its shareholder Broz.[16] Promissory notes were executed from Broz to RFB, and from Alpine to Broz.

RFB made additional advances to Alpine in 1998 and 1999 that were recorded on RFB's general ledger as "advances to Alpine PCS" and on Alpine's general ledger as "notes payable Alpine PCS -- RFB Cellular." Adjustments to those ledgers were made on 12/31/98 and on 12/31/99, to treat the advances as being made from RFB to Broz, and from Broz to Alpine.

CoBank loans to RFB were the main source of the funds that RFB advanced to Alpine. At some time in 1998, CoBank became aware that RFB was loaning the proceeds to Broz, who then loaned the amounts to Alpine.[17] Although the CoBank loan documents permitted Alpine to be the ultimate recipient of the CoBank loan proceeds, CoBank required that the funds flow solely through business entities, rather than through individuals. Broz accordingly formed Investments, in order for it to be the intermediary borrower-lender between RFB and Alpine. Once Investments was formed, Broz pledged his RFB stock as additional security for the CoBank loans, though he never personally guaranteed the loans. The CoBank loans were also guaranteed by Alpine and secured by a pledge of Alpine's assets.

Alpine incurred substantial losses in the years at issue, and the taxpayers deducted Broz's 99% share of those losses on their tax returns. The IRS disallowed approximately $36 million of the losses that the taxpayers claimed had flowed through from Alpine to Broz.

## Debt Basis -- Two Tests

In Kerzner, TC Memo 2009-76, the Tax Court attempted to synthesize the law on debt basis into a two-pronged test: "In order to acquire basis in indebtedness of an S corporation, the caselaw has required that: (1) The indebtedness run directly from the S corporation to the shareholder and (2) the shareholder make an actual economic outlay that renders him poorer in a material sense." *Kerzner* then repeated this excerpt from an earlier case to explain the "economic outlay" concept:

"In order to increase basis in a S corporation, the shareholder must make an actual economic outlay; to satisfy this requirement, even in circumstances where the taxpayer purports to have made a direct loan to the S corporation, the taxpayer must show that the claimed increase in basis was based on "some transaction which when fully consummated left the taxpayer poorer in a material sense."[18]

Unfortunately, as we will see, the authorities from which these principles are asserted to have been derived provide little guidance when it becomes necessary to determine whether either prong of the test is met in a real world situation.

## Debt Basis -- "Indirect" Indebtedness and Incorporated Pocketbooks

As noted above, in determining whether an S corporation shareholder has sufficient debt basis to be able to deduct his pro rata share of the S corporation's losses, a shareholder may take into account only indebtedness owed by the S corporation directly to the shareholder. The courts have generally policed this requirement quite strictly. For example, no debt basis was allowed for loans to an S corporation made by a partnership owned by the S corporation's shareholders.[19]

When it has been unclear whether a loan to an S corporation was made, in form, by a shareholder or by a third party, the shareholder has been denied debt basis on the grounds of the inadequacy of the form of the transaction.[20] In situations in which the substance of the transaction would, in the context of other income tax issues, clearly have led to the conclusion that the shareholder had

made a loan to the corporation, at least some courts have insisted on following the form and denying debt basis to the shareholder.[21]

Nevertheless, in two cases the Tax Court articulated an "incorporated pocketbook" theory, under which an S corporation's shareholder was allowed to claim debt basis for funds transferred directly from a related entity to the S corporation, on the basis that the related entity was really an "incorporated pocketbook" that paid expenses on the shareholder's behalf.[22]

Culnen. The taxpayer in *Culnen,* TC Memo 2000-139,[23] owned approximately half of the stock of Wedgewood, an S corporation, and 100% of the stock of Culnen & Hamilton, an S corporation that later converted to a C corporation. On 46 occasions over about three years, Culnen & Hamilton paid a total of approximately $4 million by checks and wire transfer to Wedgewood. The taxpayer claimed that the 46 payments were loans from Culnen & Hamilton to himself, the proceeds of which he then loaned to Wedgewood.

The Tax Court said that the fact that funds had originated from Culnen & Hamilton might warrant judicial scrutiny, but did not preclude the taxpayer from having debt basis in Wedgewood. The taxpayer and three other witnesses testified consistently that the taxpayer had used Culnen & Hamilton as an "incorporated pocketbook, having the corporation make payments on his behalf, which payments were posted to Culnen & Hamilton's books as loans to [the taxpayer]." The court found their testimony credible and allowed the taxpayer to have debt basis with respect to Wedgewood.

Yates. In *Yates*, TC Memo 2001-280, the taxpayer was the sole shareholder, officer, and director of Adena, an S corporation in the mining business. Adena wrote 409 checks for various personal expenses of the taxpayer. Some of the checks were payments made to Fox Trot, another S corporation owned by the taxpayer. Adena's accountant recorded the transactions on Adena's books and records as either loans to the taxpayer or distributions to him.

The Tax Court noted that the taxpayer "paid personal expenses from the Adena account and used Adena as an incorporated pocketbook." When the money was transferred to Fox Trot, the taxpayer received either distributions or a loan from Adena and then loaned the cash to Fox Trot, a series of transactions that provided the taxpayer with debt basis with respect to Fox Trot.

One commentator, with some understatement, has cautioned that, "[a]lthough the taxpayers in [*Culnen* and *Yates*], who used an incorporated pocket book to make advances to their S corporation, had success in litigation, this procedure is not recommended as sound tax planning."[24]

Ruckriegel. In contrast to *Culnen* and *Yates*, the Tax Court rejected the "incorporated pocketbook" theory in *Ruckriegel,* TC Memo 2006-78. The *Ruckriegel* taxpayers were brothers each of whom was a 50% partner in a partnership (Paulan). Paulan wrote a $1.2 million check to Sidal, an S corporation also owned by the brothers, on 7/11/97. The money's source was a $3.6 million third-party loan to Paulan.

The Tax Court was not persuaded that Paulan acted as an "incorporated pocketbook" for its partners. Over a five year period, Paulan had written a total of 55 checks, 31 to the brothers themselves and 24 to other parties. The Tax Court held that "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." [25]

No pocketbook in *Broz*. Similarly, the Tax Court in *Broz* held that the taxpayer failed to show that RFB made the payments to Alpine on Broz's behalf. Whether an entity is an incorporated pocketbook is a question of fact, and Broz was not able to prove that RFB so habitually or routinely paid his expenses so as to make RFB an incorporated pocketbook.

In addition, the year-end reclassification journal entries did not persuade the Tax Court that the transfer of money from RFB to Alpine was made through Broz. It held that "[t]he loan ran from RFB to the Alpine entities, and petitioners served as a mere conduit for the funds.[[26]] Accordingly, we find that the Alpine entities were not directly indebted to petitioners."[27]

*Broz* is the latest case confirming that the form of a transaction is highly important in the S corporation debt basis context, regardless of the substance of the transaction and regardless of whether the taxpayer could have achieved the same result under an alternative transaction form. The overriding importance of form with respect to this aspect of the debt basis inquiry was demonstrated by *Hitchins,* 103 TC 711 (1994), in which an S corporation assumed liability under a loan that a shareholder had made to a related C corporation.

The Tax Court held that the shareholder had no debt basis with respect to the S corporation, but wrote, "We are not unaware of the fact that petitioner might well have succeeded had he adopted another form of the transaction in question, e.g., by way of a novation releasing [the C corporation] from liability and obtaining a replacement note from [the S corporation]. Alternatively, petitioner could have lent $34,000 to the [S corporation], and then [the S corporation] could have paid its debt to [the C corporation], and [the C corporation] could have paid its debt to petitioner… the form of such a transaction would have been upheld, and petitioner would have had a basis in the [S corporation]'s indebtedness. But, in the area of indebtedness for the purpose of applying section 1366(d), form coupled with adequate substance or reality is not to be disregarded." (Footnotes omitted.)

A troublesome lesson taught by the court's unwillingness to apply the "incorporated pocketbook" doctrine in *Broz* is that a taxpayer may achieve a superior tax result with respect to debt basis funded by advances to an S corporation by a related entity if the taxpayer made a regular practice of failing to respect corporate formalities of the related entity and paying the taxpayer's own expenses with the related entity's funds. Apparently, the more frequently the related entity paid the taxpayer's -- and not the related entity's own -- expenses, the more likely it is that a court will treat a loan from the related entity to an S corporation as having actually been made to the S corporation by the taxpayer.

## Debt Basis -- Economic Outlay

The creation of debt basis requires not only that the loan be made directly from the shareholder to the S corporation, but it also requires that the shareholder make an actual "economic outlay" of money for the loan. In *Perry*, 54 TC 1293 (1970), the Tax Court held that debt basis was not created when a shareholder acquired an S corporation's indebtedness by issuing his own demand note to the corporation.[28]

The court in *Perry* stated that the "rule which we reach by this interpretation is no more than a restatement of the well-settled maxim which requires that 'Before any deduction is allowable there must have occurred some transaction which when fully consummated left the taxpayer poorer in a material sense.' … As we see it, the exchange of paper in the case at bar left the taxpayer herein no poorer…."[29]

While the result in *Perry* may seem unobjectionable, the development of the "economic outlay doctrine" has been confused at best, with no clear conceptual basis for distinguishing between (the shrinking number of) situations in which debt basis will be found and (the growing number of) situations in which it will be denied.

A shareholder is often treated as making an "economic outlay" when the funds that he lends to an S corporation are the proceeds of an obligation to a third party, but not when such funds are the proceeds of an obligation to a related party; the apparent basis for this distinction is that the related party might not enforce the taxpayer's obligation.

In *Underwood,* 38 AFTR 2d 76-5476, 535 F2d 309 (CA-5, 1976), *aff'g* 63 TC 468 (1975), the Fifth Circuit held that the taxpayers did not have debt basis when they substituted their own note for the debt that their S corporation owed to their other wholly owned corporation. The taxpayers would incur an economic outlay only if their other wholly owned corporation demanded payment, but it was not clear that such a demand would occur. In *Oren*, 93 AFTR 2d 2004-858, 357 F3d 854 (CA-8, 2004), *aff'g* TC Memo 2002-172, the Eighth Circuit held that a shareholder was not entitled to debt basis for back-to-back loans from related entities because the shareholder "was in the same position after the transactions as before; he was not materially poorer afterwards."

In contrast, in Rev. Rul. 75-144, 1975-1 CB 277, the Service held that debt basis was created when a shareholder, who had previously guaranteed indebtedness of an S corporation to a bank (not controlled by the shareholder), satisfied that guarantee obligation by issuing the shareholder's own note to the bank and became subrogated to the bank's position with respect to the S corporation's indebtedness.

Although the Service did not use the phrase "economic outlay" in the Ruling, it was discussed with approval in *Hitchins*, where an S corporation assumed a shareholder's debt to a related party but the assumption did not result in debt basis.[30] *Hitchins* was cited in *Kaplan*, TC Memo 2005-218, which was cited in *Kerzner*, which was in turn cited in *Broz*.

The Tax Court in *Broz* summarized the "economic outlay" doctrine, consistently with these cases, in three statements:

1) "A taxpayer makes an economic outlay for purposes of debt basis when he or she incurs a 'cost' on a loan or is left poorer in a material sense after the transaction."
2) "The taxpayer may fund the loan to the S corporation with money borrowed from a third party lender in a back-to-back loan arrangement."
3) "The taxpayer has not made an economic outlay, however, if the lender is a related party and if the repayment of the funds is uncertain."

The Tax Court held that the taxpayers failed to show that they "incurred a cost with respect to the [CoBank] loan or were otherwise left poorer in a material sense."

But the standard of whether the taxpayer became "poor" or "poorer," if taken at face value, is fundamentally nonsensical, since a taxpayer who makes a loan of his own "old and cold" cash to an S corporation has not diminished his net worth by one penny. Rather, one asset (cash) has been replaced by another asset (an obligation of the corporation). It is only upon the ultimate loss of the taxpayer's investment by the S corporation that the taxpayer becomes "poorer," but, in that regard, the taxpayer's situation is no different, in the case of a back-to-back loan from a solvent related party, from the taxpayer's situation when the taxpayer's own cash is used.

Example: An individual taxpayer owns 100% of the stock of two S corporations, Lender and Borrower. Lender, which is highly solvent, has assets of $1 million and no liabilities. Borrower has neither assets nor liabilities. At the taxpayer's request, Lender lends $100 to the taxpayer, and the taxpayer immediately relends $100 on a back-to-back basis to Borrower. Borrower proceeds to lose all the money and is unable to repay any portion of the loan.[31]

Lender either will or will not enforce the taxpayer's obligations under the loan from Lender to the taxpayer:

- If Lender does enforce those obligations, the taxpayer will be in exactly the same situation (i.e., out of pocket $100 of cash) that the taxpayer would have been in if, instead of the proceeds of a loan from Lender, the taxpayer had advanced to Borrower either the taxpayer's own "old and cold" cash or the proceeds of a loan to the taxpayer from a third party.

- If Lender does not enforce the taxpayer's obligations, the taxpayer will still be $100 poorer, because the value of the taxpayer's stock in Lender will have declined from $1 million to $999,900. The taxpayer is no richer or poorer in either case.

Rules may be needed to deal with situations in which the entity that is the source of the funds is merely "related to," but not owned by, the taxpayer, or in which the taxpayer has little or no basis in his ownership interest in that entity. Nevertheless, the "economic outlay" doctrine is an inapt tool for dealing with more ordinary cases.

One circumstance in which denial of debt basis may make sense involves a completely circular flow of funds, in which the S corporation takes the proceeds of a purported shareholder loan and lends those funds back to the business entity from which the shareholder borrowed them in the first place. Anti-abuse principles of "substance over form" or "sham transaction" may be sufficient to deal with most such cases, however, and the overlay of an "economic outlay" inquiry in such cases merely serves to confuse the issue in other situations. Thus, in *Perry, Underwood,* and *Oren*, back-to-back debts from related parties may have failed to result in debt basis to the extent that they were part of a circular flow of funds, where all of the parties were, at least in terms of their cash balances, economically in the same situation after the various loans were made as they were before.[32]

*Broz* should be distinguished from these cases, however, as a legitimate case of back-to-back debts, where the funds went from a lender (RFB) to the shareholder (Broz) and then to the S corporation (Alpine) to be used for business purposes, and the funds were *not* redeposited back with the original lender (RFB). In addition, since the funds that RFB lent to Broz originated with a loan from CoBank to Alpine, the entire series of transactions might have been considered a case of back-to-back debts arising from an unrelated lender, who is presumed to be willing to enforce repayment.

## At-Risk Rules

The Tax Court also held that Broz's share of Alpine's tax losses should be disallowed because Broz was not "at risk" with respect to those losses.[33]

RFB had borrowed cash from CoBank and transferred the amounts to Alpine. The transfers from RFB to Alpine did not appear to increase Broz's amount at risk in Alpine's activities; Broz had no personal liability for the obligations of Alpine, and, even if one were to accept that the transactions should be treated as a nonrecourse loan from RFB to Broz (acting through Investments), followed by a further loan from Broz (again acting through Investments) to Alpine, Broz had no personal liability for the obligations of Investments.

Broz argued that his pledge of RFB stock with respect to the CoBank loan constituted a pledge of property "other than property used in such activity [of Alpine]," and thus provided him with amounts "at risk" with respect to the activities of Alpine. The IRS asserted, however, and the Tax Court agreed, that stock may be property used in an activity and that, in this case, the RFB stock was used in the same activity as that conducted by Broz through Alpine, i.e., the cellular phone service business. Pledges of assets used in the same activity do not provide additional amounts at risk.

It appears that the court, at least in this portion of its opinion, was treating CoBank as making a loan -- one that was, in effect, without recourse to Broz -- directly to Broz's wholly owned disregarded entity, Investments, which then lent the proceeds to Alpine. If Broz had had personal liability with respect to the CoBank loan, he might have been at risk for the loan amount, but Broz did not personally guarantee the CoBank loan or otherwise incur any personal liability.

Another way Broz could have increased his amount at risk would have been to pledge assets to secure the loan from CoBank to Investments. Section 465(b)(2)(B) provides that a taxpayer is at risk for any amounts borrowed for use in an activity to the extent that he "has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property)." If, however, one accepts the court's conclusion that the RFB stock was used in the same activity as Alpine, Broz's amount at risk in that activity should have been increased under Section 465(b)(1)(A) by his basis in the RFB stock. So, did Broz lose this issue merely because he cited the wrong Code section in support of his position, or was there a true substantive reason that the RFB stock could not be included in Broz's amount at risk?

One notable aspect of Section 465(b)(2)(B) is that it permits a taxpayer to increase his amounts at risk by the *FMV* of *pledged* assets that otherwise are not used in the activity, while, in computing amounts at risk under Section 465(b)(1)(A), a taxpayer may take into account only the *basis* of property *used* in the activity. For instance, if a taxpayer were to borrow funds on a nonrecourse basis, secured by a pledge of investment assets unrelated to the S corporation and having a value at least equal to the amount borrowed, and use the proceeds to make a loan to (or even a stock investment in) an S corporation, the taxpayer's amounts at risk would include the full amount borrowed. If, however, the assets pledged were used in the same activity as that conducted by the taxpayer through the S corporation, the taxpayer's amount at risk by reason of this arrangement would include only the taxpayer's basis in the pledged assets. In Broz's case, the FMV of the RFB stock may have exceeded its tax basis, but Broz could not count the unrealized appreciation in the RFB stock toward his amounts at risk, even though he was economically at risk for losing that appreciation value to CoBank as a result of the pledge of the RFB stock.

## Conclusions

A shareholder of an S corporation can deduct his share of entity-level losses, but only up to the sum of his adjusted basis in his stock and his "debt basis" in any indebtedness of the S corporation to the shareholder. If the S corporation borrows sums from a non-shareholder, its shareholders are denied debt basis that would enable them to deduct losses with respect to the borrowed proceeds, and the "integrity" of this rule has been protected by denying debt basis and disallowing losses in many situations that do, in fact, involve a loan from a shareholder to an S corporation. According to the Tax Court in *Broz*, "[t]his restriction applies because the disallowed amount exceeds the shareholder's economic investment in the S corporation and, because of the limited liability accorded to S corporations, the amount does not have to be repaid."

Whatever may be said of situations in which an S corporation borrows from nonshareholders, the extension of the restrictive debt basis rules to certain cases of shareholder debt is much harder to justify.[34] A shareholder who guarantees an S corporation's third-party debt, or who has the S corporation borrow from another entity owned by the shareholder, does incur an economic risk of loss, but is nevertheless denied debt basis that would enable him to deduct flow-through losses from the S corporation. If the form of the transaction fails to result in a direct loan from the shareholder to the S corporation, the shareholder can argue for debt basis only on the theory that

the lender was the shareholder's "incorporated pocketbook," a theory that discourages respect for the corporate form and rewards people who use business entities to pay their personal expenses. And even if the taxpayer observes proper formalities in documenting a back-to-back loan from a third party, the "economic outlay" doctrine may be invoked inappropriately to deny debt basis.

As long as loan proceeds are not returned to their source through a circular flow of funds and are used by the S corporation for legitimate business purposes, the shareholder should have debt basis without regard to whether the third party lender is a related entity or unrelated entity. And there's nothing mystical about that.

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1 In an earlier case -- Broz, 137 T.C. 25 (2011), the Tax Court decided an issue relating to the classification of certain wireless cellular assets (antenna support structures, cell site equipment, and leased digital equipment) for purposes of determining those assets' "recovery period" under Section 168. In the more recent decision, the Court addressed, in addition to the issues discussed in this article, a procedural issue relating to settlement offers and questions regarding how to allocate basis among assets acquired in bulk and whether a holding company was engaged in a trade or business for purposes of deducting expenses, startup expenses, and amortization with respect to Section 197 intangibles.

2 Section 1366(a).

3 Section 1366(d).

4 Such as those expressed in Plantation Patterns, Inc., 29 AFTR 2d 72-1408, 462 F2d 712 (CA-5, 1972).

5 Estate of Leavitt, 90 TC 206 (1988) (shareholder-guaranteed bank loan did not allow losses to pass through from S corporation, and Plantation Patterns, supra note 4, does not apply to subchapter S losses as a matter of law), *aff'd*, 63 AFTR 2d 89-1437, 875 F2d 420 (CA-4, 1989). But see Selfe, 57 AFTR 2d 86-464, 778 F2d 769 (CA-11, 1985) (shareholder who guaranteed a bank loan for her corporation was entitled to factual determination of whether the bank looked primarily to her for repayment).

6 Section 465(a). Although the at-risk rules were added to the Code in 1976, their scope was expanded to cover all activities other than real estate investment in 1978, and they were further expanded (in modified form) to cover real estate investment in 1986, only a few Treasury Regulations have been issued in final form. The vast bulk of the Regulations that were proposed under Section 465 in 1979 (!) remain outstanding in proposed form.

7 Section 465(b)(1)(B).

8 Section 465(b)(2).

9 Section 465(b)(4); Reg. 1.465-20(a)(2).

10 It is not clear from the Tax Court's opinion whether the basis limitation and at-risk issues were, in effect, alternative positions taken by the Service to disallow the same losses, so that a complete victory for the Service on the basis limitation issue rendered the at-risk issue moot (and turned the court's analysis of that issue into "mere dictum"), or whether there was some component of the losses claimed by Broz that would have survived the Service's complete victory on the basis limitation issue, so that the IRS (and the Court) truly needed to address the at-risk issue as well.

11 Broz, Dkt. No. 21629-06, stipulation of facts, page 26. The Tax Court's opinion contained only a "bare bones" recitation of the facts, but additional insight can be obtained by reviewing the taxpayers' petition and the stipulation of facts.

12 Broz stipulation of facts, page 27.

13 Broz petition, page 20.

14 Broz petition, page 20; Broz stipulation of facts, page 27.

15 Broz stipulation of facts, page 27.

16 Id.

17 Broz petition, page 21.

18 Quoting Kaplan, T.C. Memo 2005-218, at 8, which in turn was quoting Bergman, 83 AFTR 2d 99-1882, 174 F3d 928, (CA-8, 1999), which itself was quoting Perry, 54 TC 1293 (1970), *aff'd*, 27 AFTR 2d 71-1464 (CA-5,

1971). This language can be traced through a chain of further citations back to this passage in a 1935 wash-sale case, Shoenberg, 16 AFTR 95, 77 F2d 446, 1935-2 CB 180 (CA-8, 1935), *cert. den.*:

> "A loss as to a particular property is usually realized by a sale thereof for less than it cost. However, where such sale is made as part of a plan whereby substantially identical property is to be reacquired and that plan is carried out, the *realization* of the loss is not genuine and substantial -- it is not real. This is true because the taxpayer has not changed his position and is no poorer than before the sale. The particular sale may be real but the entire transaction prevents the loss from being actually suffered."

Perhaps it is not surprising that, way back in 1935, a court not composed of tax specialists could confuse the question of when the taxpayer becomes poorer -- something that occurs as the taxpayer's property declines in value -- with the very different question of whether or not the taxpayer's loss has been "realized." A taxpayer who sells property to an unrelated third party, for a cash purchase price less than the property's basis, is no poorer the instant after the sale than the instant before, even though the taxpayer's loss is not "realized" until the moment of the sale. It is unfortunate that the courts have seen fit to pluck the "no poorer" rhetoric from its historic base in the wash sale area, where it was doing little harm, even if made no sense as a theoretical matter, and to apply to pass-through S corporation losses as to which the Code has never required "realization" at the shareholder level.

[19] Rev. Rul. 69-125, 1969-1 CB 207; Wise, TC Memo 1997-135.

[20] See, e.g., Harrington, 55 AFTR 2d 85-769, 605 F. Supp. 53 (DC Del., 1985) (taxpayers argued that a joint note signed by them and their S corporation was really a bank loan to them followed by their loan to their corporation, but the court rejected that argument on the facts after finding that the corporation was the principal debtor, not an accommodation maker).

[21] See cases cited in note 5, *supra*.

[22] The term "incorporated pocketbook" was used in a pejorative sense in the legislative history of the personal holding company provisions of the Code to describe a "form of tax avoidance" in which income from stocks and bonds was subject only to corporate income tax rates, which were then materially lower than individual income tax rates. *See* H. Rep't No. 704, 73d Cong., 2d Sess. 11 (1934), reprinted in 1939-1 (part 2) CB 554, 562. It is intriguing that this derogatory term became the basis on which the Tax Court decades later carved out a surprisingly taxpayer-favorable rule in the Subchapter S area.

[23] On another issue that the Tax Court had decided for the IRS, the Third Circuit reversed and held for the taxpayer: Culnen, 89 AFTR 2d 2002-383, 28 Fed Appx 116 (CA-3, 2002).

[24] *Federal Tax Coordinator* 2d (Thomson Reuters/RIA), ¶D-1780.

[25] It appears that the Tax Court was not troubled by the inconsistency inherent in even considering whether an unincorporated entity, such as a partnership, may also be considered an "incorporated pocketbook." The court did allow one of the taxpayers to claim debt basis for amounts that he had borrowed from Paulan and relent to Sidal on a back-to-back basis.

[26] By "mere conduit," the Court apparently meant to characterize Broz as no more than an agent for the remittance of funds by RFB to Alpine, since, if the Court had concluded that Broz borrowed the funds from RFB and reloaned them on a back-to-back basis to Alpine, Broz would presumably have prevailed with respect to this prong of the debt basis inquiry. By contrast, in Ruckriegel, TC Memo 2006-78, a back-to-back loan was respected and did give rise to debt basis; the Court said that it would have found the taxpayer to be a conduit "without independent legal significance," had it not been for "petitioners' involvement, at some personal inconvenience," which "represented a concrete manifestation of an intent to create obligations from Sidal to them and from them to Paulan." How great a degree of intentionally undertaken "personal inconvenience" will be sufficient to overcome an assertion of "conduit" status is not made clear by any of the cases.

[27] Prior courts have denied debt basis to taxpayers who reclassified loans from related entities as back-to-back shareholder loans after the loans had already been made. See, e.g., Burstein, TC Memo 1984-74; Bader, TC Memo 1987-30; Thomas, TC Memo 2002-108; Russell, T.C. Memo 2008-246.

[28] *See also* Rev. Rul. 81-187, 1981-2 CB 167.

[29] See discussion of the history of the "poorer" concept in note 18, *supra*.

[30] The Tax Court noted that the Ruling dealt with a "rearrangement of financial transactions involving an independent third party," as distinguished from Hitchins's "transaction involving closely related parties."

[31] If Borrower's tax losses do not represent a true economic loss -- for example, in the case of MACRS depreciation deductions that are not matched by a decline in the value of the property -- the taxpayer is not "poorer" even if Borrower's purchase of the property was funded by a loan to (or an equity investment in) Borrower of the taxpayer's own funds.

[32] If the borrowing S corporation has third-party creditors, who might be expected in a bankruptcy to seek to enforce the S corporation's right to return of those funds from the solvent original lender, an adequate economic outlay might perhaps be found even in a case involving a circular flow of funds. One need not resolve that issue favorably in order to conclude that that Tax Court's analysis in Broz was unduly harsh.

[33] As observed in note 10, *supra*, it is unclear whether the Service's victory on the debt basis issues should have mooted any consideration of the at-risk rules, or whether there was some remaining amount of losses, tentatively allowed to Broz, even after he had been denied debt basis, that was then disallowed under Section 465.

[34] Indeed, owners of LLCs classified as partnerships, whose economic position is often similar to that of S corporation shareholders can include in basis -- although often not in their amounts at risk -- even fully nonrecourse third-party debt incurred by the entity. There seems to be little reason for the courts to stretch to deny debt basis to S corporation shareholders when they have exposed funds originating with their other entities to the risk of the S corporation's business.