INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

February 07, 2006

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200619021**
Release Date: 5/12/2006
Index (UIL) No.: 1366.00-00, 1367.00-00
CASE-MIS No.: TAM-137897-05/CC:PSI:B01

Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayers =

PRS =

SCorp =

Y1 =

Y2 =

Y3 =

$a =

ISSUE(S):

1. Whether Taxpayers' loans to their S corporation in Y1 through Y3 created basis in indebtedness within the meaning of § 1366 based upon the facts described below?

2. Whether the Taxpayers' bases in stock and in indebtedness in their S corporation in an open year must be computed using previously deducted losses in excess of their bases in stock and in indebtedness in years that are now closed?

3. Whether the Taxpayers' loans that would give rise to basis in indebtedness in Y2 and Y3 create basis in indebtedness such that they may claim losses from their S corporation where they have suspense accounts by reason of claiming losses in excess of their bases in prior years?

CONCLUSION(S):

1. The Taxpayers' loans to their S corporation in Y1 through Y3 do not create basis in indebtedness within the meaning of § 1366.

2. The Taxpayers' bases in stock and in indebtedness in their S corporation in the open year must be computed using previously deducted losses in excess of their bases in stock and in indebtedness in years that are now closed.

3. The Taxpayers' loans that would give rise to basis in indebtedness in Y2 and Y3 do not create basis in indebtedness where the Taxpayers have a suspense account, but rather reduce the Taxpayers' suspense account.

FACTS:

Based on the submissions and representations made within, the relevant facts are as follows. Taxpayers, who are husband and wife, have been 50 percent partners in PRS since its inception in Y1. Taxpayers have also been 50 percent shareholders in SCorp, a subchapter S corporation (within the meaning of § 1361(a)) since its inception, also in Y1.

For each year from Y1 through Y3, PRS would loan money to Taxpayers, Taxpayers would loan money to SCorp, and SCorp would pay rent to PRS. For each loan between PRS and Taxpayers and between Taxpayers and SCorp, notes were drafted near the end of the calendar year and made within a short time frame of each other. Each note included the total outstanding loan balance (both prior year loan amounts plus current year's loan amounts), and therefore revised and superseded the loan notes issued in the prior year. Each note required no principal payments until the end of the following year. Most of these notes contained a stated interest rate, but several of the notes from PRS to Taxpayers did not. Except for one partial repayment of principal by the SCorp to Taxpayers, no repayments of either principal or interest have ever been made with respect to any of the notes.

PRS had borrowed money on a nonrecourse basis from a third party lender to acquire and construct real property. Under the borrowing arrangement, no portion of the loan proceeds could be or were used in the loan arrangements between Taxpayers, PRS, or SCorp, and loans from PRS to Taxpayers were only permitted if the third party lender approved of the loan, if the proceeds thereof were made from the net profits of PRS (after debt service to the third party lender), and if the proceeds thereof were used to fund the activity of PRS.

Because the notes Taxpayers issued to PRS were assets of PRS that the third party lender could pursue in collection in the event of default, Taxpayers claimed basis in indebtedness in the loans they made to SCorp. Consequently, Taxpayers claimed losses from SCorp for Y1 through Y3. In addition, in Y2 and Y3, Taxpayers made loans to SCorp (additional loans) that would generally give rise to basis in indebtedness.

LAW AND ANALYSIS:

1. Whether loans created basis in indebtedness

Section 1366(a) of the Internal Revenue Code generally provides that in determining the tax of a shareholder for the shareholder's taxable year in which the taxable year of the subchapter S corporation ends, there is taken into account the shareholder's pro rata share of the corporation's (A) items of income (including tax exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and (B) nonseparately computed income or loss.

Section 1366(d)(1) generally provides that the aggregate amount of losses and deductions taken into account by a shareholder under § 1366(a) for any taxable year cannot exceed the sum of (A) the adjusted basis of the shareholder's stock in the subchapter S corporation, and (B) the shareholder's adjusted basis of any indebtedness of the subchapter S corporation to the shareholder. Although what constitutes "the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder" is not specifically defined in § 1366, the report of the Senate Committee on Finance accompanying prior legislation indicates that the purpose of the section is to limit the amount of a subchapter S corporation's net operating loss that may be deducted by a shareholder to the "adjusted basis of the shareholder's investment in the corporation." S. Rep. No. 1983, 85th Cong., 2d Sess. 220 (1958).

In applying the concept of indebtedness as intended to be comparable to actual capital investment by the shareholders, the courts have consistently held that it is meant to suppose an actual economic outlay by the shareholder that finds a shareholder poorer in a material sense after the transaction than when the transaction began. Underwood v. Commissioner, 63 T.C. 468 (1975), aff'd 535 F.2d 309 (5th Cir. 1976); Oren v. Commissioner, T.C. Memo 2002-172 (2002). In Oren, a controlled S corporation lent money to the controlling shareholder, who lent the money to another

controlled S corporation, which lent the money back to the original S corporation. The court found these disbursements to be the equivalent of offsetting bookkeeping entries, especially since the loan proceeds originated and ended with the original S corporation. The court found that the circular route of the transfers indicated that the economic positions of the parties did not change, and thus there was no actual economic outlay. The Oren court further found no actual economic outlay to have occurred because the terms of the debt instruments caused the notes to be economically insignificant. The fact that no repayments were made also proved to the court the inherent lack of substance of the notes.

In the case of Taxpayers, a controlled partnership lent money to its partners, who lent money to their wholly owned S corporation, which paid rent back to the partnership. These transfers are substantially equivalent to the offsetting bookkeeping entries disapproved of in Oren. The circular route of these transfers indicate that there has been no change in the economic positions of the parties. In addition, the terms of the notes between Taxpayers, PRS, and SCorp and the lack of repayment demonstrate that the notes were economically insignificant.

In Gilday v. Commissioner, T.C. Memo 1982-242, taxpayers substituted their own personal note for the note of their S corporation that had been executed in favor of a third party bank. Because the taxpayers had become primary obligors on the loan obligation, the court allowed the taxpayers to increase their basis in indebtedness of the S corporation. The court reasoned that where a third party lender was present, there would be no question that the lender intends to force repayment, truly placing the shareholder's money at risk. Taxpayers believe that because their notes to PRS may be subject to collection if PRS defaults to the third party lender, their loans to SCorp are truly at risk and therefore an actual economic outlay has occurred.

However, the borrowing arrangement between PRS and the third party lender refute this conclusion. First, Taxpayers are not the primary obligors on the loan made by the third party lender. Second, any loans made to the owners of PRS must be approved by the third party lender, and it is extremely unlikely that the lender would permit such loans where they would jeopardize the third party lender's right to repayment. Third, any loans made to the owners of PRS must be made from the profits of PRS, net of debt service to the third party lender. Accordingly, the loans to Taxpayers could only have been made if the loan to the third party lender was current with the loan's repayment schedule. Moreover, as stated above, SCorp pays PRS rent each year, and therefore the funds used to issue loans to Taxpayers continue to be held by PRS, which it can use to further pay off the loan to the third party lender.

As a result of the circular route of funds, the economic insignificance of the terms of the notes, the lack of repayment on the notes, and the limits imposed on the Taxpayers ultimate liability to PRS, it is clear that no actual economic outlay that left the Taxpayers poorer in the material sense occurred. Therefore, the loans from Y1 through Y3 did not give rise to basis in indebtedness within the meaning of § 1366.

2. Calculation of basis in stock and in indebtedness

Because these loans did not give rise to basis in indebtedness, Taxpayers claimed roughly $a of losses in excess of their basis in stock and in indebtedness. Section 6214(b) generally provides that facts from closed years may be considered to correctly redetermine the amount of the deficiency for the year before the Tax Court. Section 1.1016-6(a) of the Income Tax Regulations provides that adjustments to basis must always be made to eliminate double deductions or their equivalent. Section 1.1016-6(b) provides that in determining basis, and adjustments to basis, the principles of estoppel apply. Section 1366(d)(2) provides an indefinite carryover of losses and deductions that are disallowed because of insufficient basis. Such disallowed losses and deductions are to be treated as incurred by the S corporation in the succeeding taxable year with respect to the shareholder.

Accordingly, the basis of the stock and indebtedness of an S corporation in an open year must be computed using previously deducted losses in excess of the basis in stock and in indebtedness in a year that is now closed. In the present case, although years before Y2 are closed for determining a tax deficiency, the correct determination of gains and losses from the closed years must be used for the purpose of determining the Taxpayers' correct bases in stock in Y2 and Y3. Because Taxpayers claimed $a in losses in excess of their basis in stock and in indebtedness, such excess must be held in a suspense account, pursuant to § 1366(d)(2), to be used in future years in computing Taxpayers bases in stock and in indebtedness.

3. Effect of loans that would create basis in indebtedness

As stated above, the additional loans satisfy the actual economic outlay doctrine and would therefore generally create basis in indebtedness to the shareholders. Where a shareholder has a suspense account by reason of claiming losses in excess of his or her basis in prior years, the shareholder's basis in stock and in indebtedness in the current year must be computed taking into account the excess losses. See § 1.1016-6(a). Thus, for example, any basis arising from income earned in subsequent years must first be reduced by the suspense account (but not below zero) before giving rise to positive basis in the shareholder's stock and in indebtedness. The same result should occur where the shareholder makes additional, bona fide loans to the S corporation rather than recognizing income from the S corporation. Basis in indebtedness to an S corporation shareholder must first be reduced by the shareholder's suspense account (but not below zero) before giving rise to additional basis in the shareholder's basis in indebtedness from which the shareholder can claim current year losses.

Therefore, basis arising from the additional loans that constitute actual economic outlays made by Taxpayers in Y2 and Y3 must first be reduced by the suspense account, before creating additional basis from which Y2 and Y3 losses can be claimed.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.