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REAFFIRMATION OF PRECEDENT: THE CONTINUING SAGA OF LOAN GUARANTEES AND SHAREHOLDER BASIS IN SUBCHAPTER S CORPORATIONS

Estate of Leavitt v. Commissioner[1]

INTRODUCTION

In 1958, Congress enacted Subchapter S of the Internal Revenue Code.[2] The purposes behind the legislation included allowing certain businesses[3] to select the corporate entity form and allow the corporation's income and losses to flow through to the shareholder for inclusion on the shareholder's personal return at individual tax rates.[4] Of particular significance is the pass through of losses, which allows the shareholder to offset the loss against current income from alternate sources. However, the Code limits this pass through of losses and other deductions to the sum of the shareholder's adjusted basis in the stock of the S corporation and the indebtedness of the S corporation to him.[5] To maximize the pass through of losses,

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1. 90 T.C. 206 (1988).

2. I.R.C. §§ 1361-1379 (1986) (original version was I.R.C. §§ 1371-1377 (1958)). For a description of the 1958 proposal, see S. REP. No. 1983, 85th Cong., 2d Sess. 87, *reprinted in* 1958 U.S. CODE CONG. & ADMIN. NEWS 4791, 4876.

3. There are various requirements for electing subchapter S status. For an exhaustive discussion of the eligibility requirements for electing subchapter S status, see J. EUSTICE & J. KUNTZ, FEDERAL INCOME TAXATION OF S CORPORATIONS, ch. 3 (rev. ed. 1985).

4. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 6.01, at 6-2 (5th ed. 1987).

5. I.R.C. § 1366(d)(1) (1986) provides:

> (d) Special rules for losses and deductions.
> (1) Cannot exceed shareholder's basis in stock and debt. The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of-
> (A) the adjusted basis of the shareholder's stock in the S corporation . . ., and
> (B) the shareholders adjusted basis of any indebtedness of the S corporation to the shareholder.

For a comparison with the former section 1374 provision, see *infra* note 28.

shareholders strongly desire to generate sufficient basis in both stock and debt.[6]

There are numerous ways a shareholder can increase his basis in the stock of an S corporation or in its indebtedness to him.[7] One way is to allow a shareholder's personal guarantee of a corporate debt to increase either stock or indebtedness basis, thus allowing a more generous conduit for losses and deductions.[8] Historically, the arguments for an increase in basis in indebtedness have been uniformly rejected.[9] However, dicta in certain cases has indicated that such guarantees may increase stock basis. Moreover, a recent decision, *Selfe v. United States*,[10] held that a shareholder may increase his or her basis in the stock of an S corporation where the court views the loan guarantee, in substance, as a loan from the lender to the shareholder with the shareholder subsequently advancing the proceeds to the corporation.[11] The *Selfe* decision was a particularly significant departure from prior authority.

In February of 1988, the United States Tax Court reconsidered the loan guarantee issue in *Estate of Leavitt v. Commissioner*.[12] The Tax Court held that a shareholder guarantee of S corporation debt, absent any actual payment on such loan guarantee, will not increase the shareholder's basis of indebtedness.[13] The court explicitly rejected the analysis of *Selfe*[14] and held that absent any economic outlay, a loan guarantee will not increase the shareholder's stock basis.[15]

This Note compares and contrasts the divergent approaches taken by the majority and dissent concerning shareholder guarantees of S corporation debt. The majority takes a "pure" substance over form approach: without regard to debt-equity principles, the shareholder must prove that the guarantees were, in substance, loans from the bank to the shareholder who

6. Comment, *Subchapter S Loss Limitation: The Effect of Shareholder Loan Guarantees on Basis*, 40 Sw. L.J. 1241, 1241 (1986).

7. Such methods for increasing stock basis include contributing cash to the corporation, purchasing additional stock, or contributing property to the corporation. Methods for increasing basis in the indebtedness from the corporation to the shareholder include lending cash, borrowing personally from a lender then lending the proceeds to the corporation, paying a corporate debt guaranteed by the shareholder, and, subject to certain conditions, substituting a shareholder's note for a shareholder-guaranteed corporate debt. *See* J. EUSTICE & J. KUNTZ, *supra* note 3, § 10.03[2] (discussing successful and unsuccessful methods of stock and debt basis generation).

8. Comment, *supra* note 6, at 1241.

9. *See* cases cited *infra* notes 47 and 60.

10. 778 F.2d 769 (11th Cir. 1985).

11. *Id.* at 773.

12. 90 T.C. 206 (1988).

13. *Id.* at 212.

14. *Id.* at 216.

15. *Id.*

subsequently contributed the proceeds to the S corporation.[16] By contrast, the dissent uses a debt-equity approach: debt-equity principles should be applied to determine the substance of a shareholder loan guarantee,[17] and application of such principles is intertwined with the substance over form analysis.

Leavitt involved a subchapter S corporation, VAFLA Corporation (VAFLA), formed in 1979 to operate an amusement park in Florida.[18] Petitioners paid $10,000 for their shares.[19] In August, petitioners and other shareholders signed guarantee agreements, with each shareholder agreeing to be jointly and severally liable for all indebtedness of VAFLA to the Bank of Virginia.[20] On September 12, 1979 VAFLA borrowed $300,000 from the Bank of Virginia to fund current and future operating deficits.[21] Seven shareholders, including petitioners, guaranteed the loan personally, and the loan's approval hinged directly on the wealth of the guarantors.[22] VAFLA consistently displayed the loan as a shareholder loan on its financial statements and tax returns, but VAFLA made all interest and principal payments to the Bank of Virginia and neither VAFLA nor petitioners characterized such payments as constructive dividends.[23]

In the taxable years ending September 30, 1979, 1980 and 1981, VAFLA suffered mounting net operating losses.[24] Petitioners deducted losses on their personal tax returns in excess of $10,000,[25] with the Commissioner disallowing the excess.[26] Petitioners contended that "their guarantees of the $300,000 loan to the corporation . . . increased their basis in their stock sufficiently to allow deductions for their proportionate share of losses attributable to the corporation during the years in issue."[27] The Commissioner contended that under former section 1374(c)(2) of the Code[28] pe-

16. *Id.* at 213-14.
17. *Id.* at 223.
18. *Id.* at 208.
19. *Id.* Petitioners (plural) in this instance refer to the estates of Daniel and Evelyn Leavitt, and Charles D. Fox, III, Executor, consolidated with the case involving Anthony D. and Marjorie F. Cuzzocrea. *Id.* at 206 n.1.
20. *Id.* at 208-09.
21. *Id.*
22. *Id.*
23. *Id.*
24. *Id.* at 208.
25. *Id.*
26. *Id.* at 210.
27. *Id.*
28. Former I.R.C. § 1374(c) (1958) provided, in part:

> (2) Limitation.- A shareholder's portion of the net operating loss of an electing small business corporation for any taxable year shall not exceed the sum of-
>
> (A) the adjusted basis . . . of the shareholders stock in the electing small business corporation, determined as of the close of the taxable year of

titioners could not deduct losses in excess of their $10,000 stock basis.[29]

SUBSTANCE OVER FORM

Central to the petitioners' argument was a "substance over form" view of the guarantee transaction.[30] Petitioners argued that the transaction was, in substance, a loan from the bank to petitioners followed by the contribution of the loan proceeds to the corporation's capital, thus resulting in a basis-increasing capital investment.[31]

The Supreme Court first recognized the substance over form doctrine in its 1935 decision of *Gregory v. Helvering*.[32] In *Gregory*, the Court found that a corporate reorganization by the taxpayer, while facially complying with the Code statute, was nonetheless "an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else."[33] The Court thus held that the substance of the transaction controlled the tax effects. More recently, in *Diedrich v. Commissioner*,[34] the Court reiterated that "the 'reality,' not the form of the transaction . . . govern[s]."[35]

While courts and the commissioner exalt substance over form reasoning, they nonetheless often require taxpayers to stick to their chosen form of the transaction. As noted in *Legg v. Commissioner*:[36] "[a] taxpayer cannot elect a specific course of action and then when finding himself in an adverse situation extricate himself by applying the age old theory of substance over form."[37] Although the tax consequences of a chosen transactional form

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> the corporation . . ., and
> (B) the adjusted basis . . . of any indebtedness of the corporation to the shareholder, determined as of the close of the taxable year of the corporation. . . .

In 1982, Congress revised the subchapter S rules in the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (1982). The limitations described in former section 1374 were reenacted in section 2 of the Subchapter S Revision Act of 1982 at I.R.C. § 1366(d)(1) (1982). Future references in this Note will refer to the current section 1366(d)(1) of the Code.

29. 90 T.C. at 210.

30. *See generally* Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859 (1982); Comment, *Substance Versus Form in the Interpretation of the Internal Revenue Code*, 1967 U. OF ILL. LAW. F. 816.

31. 90 T.C. at 212.

32. 293 U.S. 465 (1935).

33. *Id.* at 470.

34. 457 U.S. 191 (1982).

35. *Id.* at 196.

36. 57 T.C. 164 (1971).

37. *Id.* at 169.

may constrain taxpayers,[38] the Internal Revenue Service and courts freely can look behind the "face value" of a transaction and make a "careful scrutiny" to determine its substance.[39] This tenet appears to give the Commissioner a "sword and a shield—the Commissioner's sword cuts both ways, but the taxpayer has been unable to penetrate the Commissioner's shield of form."[40]

In the long history of cases involving shareholder guarantees of loans to subchapter S corporations, the substance over form argument has met with little success.[41] In *Brown v Commissioner*,[42] the Sixth Circuit stated the general rule for guaranteed transactions: "[p]etitioners are liable for the tax consequences of the transaction that they actually executed; they may not reap the benefits of some other transaction that they might have effected instead."[43] Accordingly, shareholders who wish to guarantee creditor loans, and then use a substance over form argument to increase stock or indebtedness basis fight an uphill battle. In the shareholder guarantee context, only the *Selfe*[44] decision has approved such an argument, and only under limited circumstances.[45]

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38. *See* Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974). The Court noted:

> [t]his Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice whether contemplated or not . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not.

Id. at 149. Similarly, in Central Tablet Mfg. Co. v. United States, 417 U.S. 673, 690 (1974), the Court stated "[t]ax consequences follow what has taken place, not what might have taken place."

39. Silverstein v. United States, 349 F. Supp. 527, 532 (E.D. Va. 1972) (quoting Limericks, Inc. v. Commissioner, 165 F.2d 483, 484 (5th Cir. 1948)).

40. Comment, *supra* note 30, at 817 (footnotes omitted) (citing Bergash v. Commissioner, 43 T.C. 743 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966); Holz v. United States, 176 F. Supp. 330 (D. Minn. 1959); Gallagher v. Commissioner, 39 T.C. 144 (1962)).

41. Brown v. Commissioner, 42 T.C.M. (CCH) 1460, 1463-64 (1981), *aff'd*, 706 F.2d 755 (6th Cir. 1983) (form of transaction was not a loan from credit corporation to petitioners, who loaned the funds to the bank; substance involved a guarantee which matched the form); Thompson v. Commissioner, 36 T.C.M. (CCH) 157, 162 (1977) (taxpayer was a guarantor; refusal to hold that he "had a different role"); Duke v. Commissioner, 35 T.C.M. (CCH) 229, 231 (1976) (court refused to view guarantee transactions as constructive loans; view would "distort the actualities").

42. 706 F.2d 755 (6th Cir. 1983), *aff'g* Brown v. Commissioner, 42 T.C.M. (CCH) 1460 (1981).

43. 706 F.2d at 756.

44. Selfe v. United States, 778 F.2d 769 (11th Cir. 1985); *see also supra* note 10 and accompanying text.

45. In *Selfe*, the court placed emphasis on the fact that the notes guaranteed by the shareholder were issued by a "thinly capitalized corporation and had more

BASIS OF INDEBTEDNESS FROM CORPORATION TO SHAREHOLDER

In *Leavitt* the majority and dissent disposed of any arguments concerning an increase in basis of indebtedness from the corporation to the shareholder.[46] The majority noted that:

> the fact that [the] shareholders may be primarily liable on indebtedness of a corporation to a third party does not mean that this indebtedness is "indebtedness of the corporation to the shareholder" within the meaning of section 1374(c)(2)(B). No form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the obligation . . . .[47]

Petitioners in *Leavitt* had never been required to pay any of the loan they guaranteed,[48] and thus were denied any indebtedness basis increase. In many reported cases, and as the majority noted in *Leavitt*,[49] an actual investment or economic outlay is required for a basis increase.[50] The economic outlay

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equity characteristics than debt." 778 F.2d at 774. The court also noted that central to the substance over form argument was the fact that the loan to the corporation was secured by the taxpayer's personal property, and that the bank was primarily looking to the taxpayer for repayment. *Id.* at 771. However, whether the bank actually looked to the taxpayer for repayment was unclear, and thus this factual issue was to be determined upon remand. *Id.* at 771-72 n.3.

46. 90 T.C. at 211, 220.

47. Estate of Leavitt v. Commissioner, 90 T.C. 206, 211 (1988) (quoting Raynor v. Commissioner, 50 T.C. 762, 770-71 (1968)); *see also* Brown v. Commissioner, 706 F.2d 755, 756 (6th Cir. 1983); Underwood v. Commissioner, 535 F.2d 309, 312 (5th Cir. 1976); Harrington v. United States, 605 F. Supp. 53, 56 (D. Del. 1985); Neal v. United States, 313 F. Supp. 393, 396 (C.D. Cal. 1970); Williams v. Commissioner, 41 T.C.M. (CCH) 844, 848 (1981); Albert v. Commissioner, 41 T.C.M. (CCH) 591, 595-96 (1980); Mirow v. Commissioner, 34 T.C.M. (CCH) 628, 630-31 (1975); Parson v. Commissioner, 33 T.C.M. (CCH) 789, 792 (1974), *aff'd mem.*, 554 F.2d 1070 (9th Cir. 1977); Frankel v. Commissioner, 61 T.C. 343, 347 (1973); Prashker v. Commissioner, 59 T.C. 172, 177 (1972); Borg v. Commissioner, 50 T.C. 257, 264-65 (1968); Priv. Ltr. Rul. 84-26-006 (June 29, 1984).

48. Estate of Leavitt v. Commissioner, 90 T.C. 206, 212 (1988).

49. *Id.*

50. *Id.* at 217 (citing Perry v. Commissioner, 54 T.C. 1293, 1296 (1970)). The *Leavitt* majority also found support in the language of the report of the Committee on Finance of the Senate:

> The amount of the net operating loss apportioned to any shareholder pursuant to the above rule is limited under section 1374(c)(2) to the adjusted basis of the shareholder's *investment* in the corporation; that is, to the adjusted basis of the stock in the corporation owned by the shareholder and the adjusted basis of any indebtedness of the corporation to the shareholder.

Id. (emphasis added).

requirement is, however, somewhat nebulous when put into practice.[51] There is often confusion over whether a present or future economic outlay is required for an increase in basis of indebtedness.[52]

BASIS IN STOCK

The *Leavitt* petitioners argued that their guarantee of the S corporation's debt was, in substance, a contribution to the equity of the corporation.[53] Related to this contention is the issue of the applicability of debt-equity principles to shareholder guarantee questions. An analysis of debt-equity principles is often required to determine whether securities issued by a corporation are, in substance, debt or equity for taxation purposes.[54] Also, albeit less frequently, shareholder loan guarantees can be subject to debt-equity analysis.[55]

The Code sets forth several factors for determining whether a debtor/creditor or corporation/shareholder relationship results from some relevant

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51. J. EUSTICE & J. KUNTZ, *supra* note 3, at § 10.03[2][i] n.184 (rev. ed. Cumulative Supp. No. 2, 1988).

52. The quote from *Raynor* used in the majority's opinion suggests a present economic outlay. However, as noted in Rev. Rul. 75-144, 1975-1 C.B. 277, when a shareholder substitutes his or her note for that of a corporation, and subrogation occurs, the corporation becomes indebted to the shareholder for the face amount of the note given to the creditor, and the shareholder is allowed a basis step-up. *Id.* at 278. In Gilday v. Commissioner, 43 T.C.M. (CCH) 1295 (1982), the Tax Court further noted that subrogation, as per state law, need not occur. *Id.* at 1297. If a shareholder substitutes his or her note for that of the corporation, and thus becomes the primary obligor, then the shareholder can increase his or her basis in indebtedness from the corporation to the shareholder. *Id.* The court indicated that a *future* economic outlay will suffice.

The focus in *Gilday* and Rev. Rul. 75-144 is really on a decrease in the shareholder's net worth from incurring an obligation which produces basis, as opposed to any economic outlay argument. Perhaps a better standard would involve basis increase when a shareholder's personal net worth has been reduced by assuming an obligation, as opposed to requiring a certain "economic outlay".

53. 90 T.C. at 212.

54. The taxation issue primarily involves a corporation and shareholder seeking to have distributions from the corporation treated as payments of interest and principal to the shareholder. This allows for a deduction to the corporation for interest and a tax free return of capital to the shareholder, insofar as the principal portion of the payment is concerned. Debt-equity analysis can reclassify this situation, treating debt instruments as actual equity contributions. Thus, interest and principal payments become nondeductible after-tax dividends paid by the corporation and taxable dividend income to the shareholder.

55. Casco Bank & Trust Co. v. United States, 544 F.2d 528, 534-35 (1st Cir. 1976); Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712, 719 (5th Cir. 1972); Smyers v. Commissioner, 57 T.C. 189, 198 (1971); Santa Anita Consol. v. Commissioner, 50 T.C. 436, 550 (1968).

transaction.[56] Moreover, courts have developed additional factors,[57] none of which are controlling.[58] As the dissent noted, many of these debt-equity factors were present in *Leavitt*.[59] The primary disputed issue was whether a court should apply debt-equity principles at any point in a shareholder guarantee situation to reclassify the guarantee as, in substance, an equity contribution.

Leavitt held, in direct contradiction to the Eleventh Circuit *Selfe* decision, that "a shareholder's guarantee of a loan to a subchapter S corporation may not be treated as an equity investment in the corporation absent an economic outlay by the shareholder."[60] The *Leavitt* majority followed a line of cases generally holding that guarantees of corporate debt will not increase stock basis.[61] It declined to apply debt-equity analysis to loan guarantees in subchapter S cases, and restricted the use of such principles to subchapter C corporations.[62] The court explained its refusal to apply debt-equity principles as based upon congressional intent to limit

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56. I.R.C. § 385(b)(1986) provides:

(b) Factors. The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular fact situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exits. The factors so set forth in the regulations may include among other factors:

(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,

(2) whether there is a subordination to or preference over any indebtedness of the corporation,

(3) the ratio of debt to equity of the corporation,

(4) whether there is convertibility into the stock of the corporation, and

(5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

57. 90 T.C. at 231. The dissent noted several of these debt-equity factors, including "(7) the intent of the parties; (8) "thin" or inadequate capitalization; (9) identity of interest between creditor and stockholders; . . . (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets . . . ." *Id.*

58. Tyler v. Tomlinson, 414 F.2d 844, 848 (5th Cir. 1969).

59. 90 T.C. at 232-33.

60. 90 T.C. at 216.

61. Brown v. Commissioner, 706 F.2d 755, 756 (6th Cir. 1983), *aff'g* 42 T.C.M. (CCH) 1460, 1463-64 (1981); Wheat v. United States, 353 F. Supp. 720, 722-23 (S.D. Tex. 1973); Calcutt v. Commissioner, 84 T.C. 716, 720 (1985); Blackman v. Commissioner, 41 T.C.M. (CCH) 1512, 1515 (1981); Thompson v. Commissioner, 36 T.C.M. (CCH) 157, 161 (1977); Duke v. Commissioner, 35 T.C.M. (CCH) 229, 231 (1976); Blum v. Commissioner, 59 T.C. 436, 438 (1972).

62. *Id.* Although the majority doesn't elaborate further on its refusal, there could be another reason. Debt-equity analysis was originally developed to deal with shareholder/corporation transactions that were designed to avoid double taxation of dividends. *See supra* note 54. The Fifth Circuit Court of Appeals extended this

deductions for S corporation shareholders.[63] Congress used "investment" as meaning actual economic outlay.[64] Absent such an outlay, the majority concluded that subchapter S shareholders "could readily skirt the limitation embodied in section 1374(c) and thereby erect a tax shelter that Congress never intended to create."[65]

Essentially, the majority would apply a two step analysis when analyzing shareholder loan guarantees. First, the shareholder would have the burden of proving that the substance of the transaction is a loan from the creditor to the shareholder, who subsequently contributes the funds to the corporation. Second, if applicable, debt-equity principles would determine the nature of the transaction between the shareholder and the corporation. As previously noted, the majority would refuse to apply debt-equity principles to shareholder loan guarantees in the subchapter S area.[66]

Citing *Blum v. Commissioner*,[67] and *In re Breit*,[68] the *Leavitt* Tax Court noted that, in past decisions, shareholder guarantees of corporate loans from banks to S corporations were not considered, in substance, to be capital contributions.[69] The taxpayers in such cases failed in their burden of proving that such guarantees were actually loans to the shareholders, who then contributed such funds to the S corporation.[70] Thus, the courts never reached the debt-equity issue because the taxpayer failed to prove that the substance of the transaction was not its actual form.[71]

The majority of the Tax Court, addressing this issue, indicated certain factors which may be persuasive in convincing a court that a loan from a creditor to an S corporation guaranteed by a shareholder, would be, in substance, an equity contribution by a guarantor. Such factors would include whether the guarantors could "dispose of the proceeds of the loan as they wish[]," or if payments on the loan were "reported as constructive dividends on the corporation's Federal income tax returns" or on the guarantors'.[72] Unless these, and perhaps other factors, are present, such transactions are

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analysis to subchapter C corporations and guarantees of corporate debt in Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972). Finally, this guarantee analysis was used in a subchapter S context in Selfe v. United States, 778 F.2d 769 (11th Cir. 1985). This "three step" transfer of debt-equity analysis from its origins to subchapter S guarantee issues could be viewed as "stretching" the principle too far.

63. 90 T.C. at 216.
64. *Id.* at 216-17. *See supra* note 50 and accompanying text.
65. *Id.* at 217 (citing Brown v. Commissioner, 706 F.2d at 756).
66. *See supra* notes 62-65 and accompanying text.
67. 59 T.C. 436, 439 n.4 (1972).
68. 460 F. Supp. 873, 875 (E.D. Va. 1978).
69. 90 T.C. at 215.
70. *Id.*
71. *Id.*
72. *Id.* at 213-14.

to be considered loans from a creditor to an S corporation guaranteed by shareholders.[73]

The majority's decision invites criticism on two points. The first involves the capital outlay requirement. The court noted that the "petitioners' guarantees . . . do not constitute cash or other property."[74] Essentially, insofar as stock basis is concerned, the majority followed *Perry v. Commissioner*[75] which held that "before any deduction is allowable there must have occurred some transaction which when fully consummated left the taxpayer poorer in a material sense."[76] This language suggests a required *present* economic outlay. However, for purposes of increasing basis in indebtedness from the corporation to the shareholder, a note subrogation transaction requires *future* economic outlay.[77] This unusual dichotomy, a "stricter" outlay required for stock basis step-up as opposed to basis in indebtedness, is not necessarily indicated by the solitary term "investment" as per the Senate Committee on Finance's report, which is used to refer to both types of adjusted basis.[78] The *Leavitt* majority, by using language that suggests a present economic outlay, may be setting too narrow a standard given that prior decisions focus more on a decrease in shareholder net worth as the basis increase standard.[79]

The second criticism involves the majority's refusal to apply debt-equity principles in the subchapter S area. As the dissent pointed out, "all, or nearly all, subch. S cases cite subch. C precedent or subch. S precedent which relied on subch. C precedent."[80] The dissent further commented that the majority misstated *Blum's* holding.[81] In *Blum*, the Tax Court applied debt-equity principles in determining that the taxpayer failed in his burden of proof of showing that the substance of the transaction was a loan to the shareholder, who proceeded to contribute the funds to the corporation.[82] This reasoning contrasts with the majority's contention that the *Blum* court did not apply debt-equity principles because the taxpayer failed in his burden of proof in *first* showing that the substance of the transaction was a loan from the creditor to the shareholder.[83] This contrary interpretation

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73. *Id.*
74. *Id.* at 212.
75. 54 T.C. 1293 (1970).
76. 54 T.C. at 1296 (quoting Horne v. Commissioner, 5 T.C. 250, 254 (1945)).
77. Although the shareholder who gives his own note in subrogation for the debt of the corporation has given up "property," the shareholder hasn't, at *present*, contributed personal funds. *See supra* note 50.
78. *See supra* note 50.
79. *See supra* note 52.
80. 90 T.C. at 225 n.9.
81. *Id.* at 222.
82. 59 T.C. at 439-40.
83. 90 T.C. at 222.

of the *Blum* holding is also at odds with language in other authority suggesting that debt-equity considerations may be applicable in determining the substance of a transaction.[84] It is at the very least arguable that debt-equity principles should be employed at some point in the analysis to determine the substance of guaranteed loans. Thus the majority's absolute refusal to ever consider such principles in an S corporation loan guarantee situation could lead to difficulty in analyzing unusual S corporation transactions.[85]

The dissent posed the opposite argument, that the transaction was, in substance, a loan from the bank to the shareholders, who then made a capital contribution of the proceeds.[86] The primary difference between the majority and minority opinions was whether debt-equity principles should be applied. The dissent argued that "[t]raditional debt-equity principles are applied to determine the substance of a transaction. After making such determination, the substance of the transaction, not the form, is evaluated for federal income tax purposes."[87] The dissent noted that it matters little whether we are dealing with a subchapter S or subchapter C corporation: "[i]f a guarantee of a corporate debt is in substance a capital contribution, then it is a capital contribution . . . ."[88] According to this view, debt-equity principles should be applied to characterize shareholder guarantees as capital contributions, and such application is an intrinsic part of the substance over form analysis.

The dissent's analysis is based upon the Fifth Circuit decision of *Plantation Patterns, Inc. v. Commissioner*.[89] In *Plantation Patterns*, an investment banker guaranteed certain obligations of a newly formed cor-

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84. *See* Selfe v. United States, 778 F.2d at 774; *In re* Breit, 460 F. Supp. at 875; Albert v. Commissioner, 41 T.C.M. (CCH) 591, 595 (1980).

85. The dissent suggests a hypothetical whereby a C corporation has a loan from a bank guaranteed by a shareholder. Using debt-equity principles in a subchapter C context, the court determines that the debt is, in substance, a capital contribution, and disallows the interest deduction. If the C corporation becomes an S corporation, are the interest payments now deductible, considering the majority's refusal to apply debt-equity principles in a subchapter S context? 90 T.C. at 224 n.7. Another situation could arise when an S corporation shareholder-guarantor actually pays part of an obligation on an S corporation loan from a bank. The shareholder would be able to increase his basis in indebtedness for the amount of the payment. However, in some circumstances, where the corporation is virtually insolvent and the shareholder never has any actual intent of demanding interest or principal payments, shouldn't such a payment be better classified under debt-equity principles as a capital contribution? Would the majority's refusal to apply debt-equity principles create a potential tax advantage for the shareholder? If bankruptcy and dissolution were necessary, would the shareholder's indebtedness interest be equitable as compared to other creditors?

86. 90 T.C. at 228.

87. *Id.* at 223-24.

88. *Id.* at 224.

89. 462 F.2d 712 (5th Cir.), *cert. denied*, 409 U.S. 1076 (1972).

poration so that the corporation would have unsecured debt, and would thus be able to obtain additional financing.[90] The court looked to traditional debt-equity principles in recharacterizing the guarantees, noting that the corporation used a large portion of the debt to purchase capital assets, that the corporation was thinly capitalized, and that there was identity of interest between the shareholder and guarantor.[91] The court also placed significant weight on the fact that the sellers "looked at all times to [the banker's] guarantees as the real insurance for the notes."[92] Thus, the court recharacterized a guarantee as an equity contribution, in substance, after applying debt-equity principles.

Another case following this pattern, and which the *Leavitt* petitioners and dissent relied on heavily is *In re Lane*.[93] In *In re Lane*, the court applied debt-equity factors to a shareholder guarantee situation, concluding that it was the shareholders "intent at the time the guaranties were extended to use the guaranties as short-term substitutes for infusion of more capital stock."[94] Although in *In re Lane* the shareholder did eventually pay on the guarantees, the dissent in *Leavitt* noted that the crux of the issue was that debt-equity principles, applied at the time the guarantees were made, recharacterized the guaranteed debt as a capital contribution.[95]

Selfe, a subchapter S case mentioned above, applied the *Plantation Patterns* and *In re Lane* analysis. In *Selfe*, a subchapter S corporation received financing from a bank, with the shareholder guaranteeing the corporation's indebtedness to the bank, and securing the loans with personal collateral.[96] The corporation never defaulted, even when suffering losses for three years.[97] The shareholder contended that the loan was, in substance, made to her, and she then contributed the proceeds to the corporation's capital.[98] The Eleventh Circuit, following *Plantation Patterns*, held that a guarantee may increase the basis in an S corporation where the facts show that, in substance, the loan was from the creditor to the shareholder, who then made an equity contribution.[99] Central to this determination is that the "facts indicate that the lender is looking primarily to the stockholder for repayment."[100] The court applied a "thirteen factor analysis" to de-

90. 462 F.2d at 716.
91. *Id.* at 722-23.
92. *Id.* at 724.
93. 742 F.2d 1311 (11th Cir. 1984).
94. *Id.* at 1320.
95. 90 T.C. at 226.
96. 778 F.2d at 770-71.
97. *Id.* at 771.
98. *Id.*
99. *Id.*
100. *Id.* at 771.

termine the taxpayer's interest in the corporation.[101] These debt-equity factors are then used to determine whether a guarantee is, in substance, an equity contribution or loan.[102] However, the court remanded the case after concluding that there were still material facts at issue concerning whether the bank actually looked to the guarantor for repayment, and whether debt-equity factors indicated that the guarantee was, in substance, an equity contribution.[103]

The *Leavitt* dissent applied the analysis in *Plantation Patterns* and *Selfe* to the *Leavitt* facts and noted several debt-equity factors showing that the guarantees were, in substance, equity contributions.[104] After evaluating these factors, it concluded that the petitioners should be allowed a stock basis increase.[105] To determine the amount of the increase, it applied Virginia State law and found that the shareholder guarantors were "effectively obligated to pay only their aliquot portion of the indebtedness."[106] With seven shareholders, two of which were petitioners, each petitioner would be obligated to pay on one-seventh of the $300,000 debt, or $42,857, which would be the capital contribution amount.[107]

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101. *Id.* at 773 (citing *In re* Lane, 742 F.2d 1311 (11th Cir. 1984), and Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972), for traditional debt-equity factors). The thirteen *Mixon* factors include:

(1) the names given to the certificates evidencing the indebtedness;
(2) the presence or absence of a fixed maturity date;
(3) the source of payments;
(4) the right to enforce payment of principal and interest;
(5) participation in management flowing as a result;
(6) the status of the contribution in relation to regular corporate creditors;
(7) the intent of the parties;
(8) "thin" or adequate capitalization;
(9) identity of interest between creditor and stockholder;
(10) source of interest payments;
(11) the ability of the corporation to obtain loans from outside lending institutions;
(12) the extent to which the advance was used to acquire capital assets; and
(13) the failure of the debtor to repay on the due date or to seek a postponement.

Id. at 402.

102. 778 F.2d at 774.

103. *Id.* at 775.

104. 90 T.C. at 232. The dissent noted the following factors. The bank was looking solely to the shareholder/guarantor for repayment because of the financial strength of the guarantors and the weak condition of the corporation. *Id.* The corporation's liabilities significantly exceeded its assets and it was thinly capitalized. *Id.* The corporation could not have borrowed funds without outside support. *Id.* at 233. And, over half the borrowed funds were used to acquire capital assets or reduce capital indebtedness. *Id.* at n.17.

105. 90 T.C. at 234-35.

106. *Id.* at 235-36.

107. *Id.* at 236.

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There are two primary criticisms of this approach. The first involves the use of debt-equity principles in the substance over form argument. As previously indicated, an essential element in the *Selfe* and *Plantation Patterns* analysis was that the lender looked primarily to the guarantor for repayment.[108] However, as a realistic matter, this criteria may never be actually satisfied even when resorting to debt-equity factors. The lender may never have a "primary" obligor: as long as someone pays, the lender is satisfied.[109] Indeed, a plausible retort could be, "If the bank looked primarily to the shareholder/guarantor, why didn't the bank simply loan the proceeds to the shareholder and secure the loan with corporate assets?"[110] From a practical standpoint, the primary obligor requirement may not be a workable standard for a shareholder, or court, to attempt to follow.[111]

The second criticism concerns the majority's economic outlay requirement. The dissent considered this requirement satisfied by the substance over form determination.[112] But the end result in the dissent's analysis is that, despite a substance argument, the shareholder is not actually any worse off financially by a present outlay of funds. Nor is the shareholder primarily liable on the debt as in a *Gilday v. Commissioner*[113] subrogation case, and is not obligated for future fund outlays. Additionally, the dissent conveniently overlooked part of the economic outlay issue addressed in *Selfe*. In *Selfe*, the shareholder provided collateral for the loan.[114] The court noted that "a guarantor who has pledged stock to secure a loan has experienced an economic outlay to the extent that the pledged stock is not

108. *Selfe*, 778 F.2d at 774; *Plantation Patterns*, 462 F.2d at 724.

109. Bogdanski, *Shareholder Guarantees, Interest Deductions, and S Corporation Stock Basis: The Problems with Putnam*, 13 J. CORP. TAX'N 264 (1986).

> The courts may ask, "To whom did the lender primarily look for repayment?" But the answer may come back: "The lender didn't care so long as *someone* made all the payments." Indeed, one suspects that any competent loan officer's conditioned reflex in dealing with a closely held corporation is to demand personal guarantees from every shareholder in sight; the fact that such credit support is actually given should not in itself control.

Id. at 269.

110. *See id.* at 272 (citing Tech. Adv. Mem. 84-43-002 (July 6, 1984)).

111. *Id.*

112. 90 T.C. at 230. The dissent noted that "[i]n such a situation, the shareholder/guarantor's deemed transfer of the loan proceeds to the corporation is the economic outlay." *Id.*

However, the same statutory concerns of the majority are resurrected: Congress used the term "investment" in the 1958 Senate proposal, S. REP. No. 1983, 85th Cong., 2d Sess. 87, *reprinted in* 1958 U.S. CODE CONG. & ADMIN. NEWS 4791, 5008, which the majority found implied a present material outlay need occur. 90 T.C. at 217.

113. 43 T.C.M. (CCH) 1295 (1982). *See supra* note 52 for a description of the basis effects of a note subrogation transaction.

114. 778 F.2d at 771.

available as collateral for other investments. The guarantor . . . has lost the time value or use of its collateral."[115] In *Leavitt*, there was no pledge of collateral for the notes, making it distinguishable from *Selfe*. The petitioners' and dissent's arguments concerning the economic outlay concept appear less persuasive in light of the statutory language in the Senate Report mentioned above, and the recognition in *Selfe* of the use of personal assets as collateral to satisfy the capital outlay requirement.

CONCLUSION

Despite the *Selfe* decision and the holdings in *Plantation Patterns* and *In re Breit*, the *Leavitt* decision suggests that "*Selfe* should not be relied upon for planning purposes, even for taxpayers in the Eleventh Circuit. Instead, a direct loan to the shareholder and either a loan or contribution to the corporation is the proper planning technique."[116] Another appropriate planning technique would be to consider a *Gilday*-type transaction, and let the shareholder subrogate his note for that of the corporation. The subrogation could occur, with the lender's consent, at any time. Further, this subrogation technique appears to be supported by better authority.[117] As a final planning point, it should be noted that not all is lost should a subchapter S corporation shareholder fail to realize all possible losses because of a lack of basis. In light of the Subchapter S Revision Act of 1982,[118] planning to achieve maximum loss deductions is less critical due to the provision for carryover of losses, a provision not in effect at the time *Leavitt* arose.[119]

Even with academic approval of the rational and result in *Selfe*,[120] the majority of jurisdictions, as well as the Tax Court, have authority rejecting the substance over form argument for loan guarantees.[121] Courts have heavily relied on the economic outlay criteria, and will probably require some actual monetary detriment before allowing basis increase.[122]

115. *Id.* at 772-73 n.7.

116. August, *"Selfe" Reflections: The Search for Basis for S Shareholder Guarantees of Corporate Indebtedness*, 3 J. PART. TAX'N 260, 265 (1986).

117. *See supra* note 52.

118. Pub. L. No. 97-354, § 2, 96 Stat. 1669 (1982).

119. The Code now provides for a suspension of losses that exceed shareholder's basis in a tax period, and allows them to be offset against gain in future periods. I.R.C. § 1366(d)(2) (1986). Pre-1982 law did not provide for such carrying forward: losses not taken were lost forever. Thus, much of the urgency and need for arguing substance over form in guarantee situations in order to get as much net operating loss as possible appears to have been blunted.

120. J. EUSTICE & J. KUNTZ, *supra* note 3, at § 10.03 [2][i] (referring to *Selfe* as a "well reasoned decision").

121. *See* cases cited *supra* notes 41 and 47.

122. *See* cases cited *supra* note 60; *see also supra* notes 61-65 and accompanying text.

Should S corporation shareholders attempt a substance over form argument in a guarantee context, the requirements of *Selfe* should be followed closely. Of some significance would be the use of collateral in the guarantee transaction to attempt to meet the economic outlay requirement.[123] Moreover, the substance over form argument should be restricted to attempted increases in stock basis, and not basis of indebtedness.[124] In the basis of indebtness context, the argument lacks precedential authority.[125] In addition, as the factors comprising the argument are fufilled, the characterization of the contribution as a loan becomes more superficial. The very factors used in *Selfe* and *Plantation Patterns*, traditional debt-equity principles and the guarantor as primary obligor requirement, would work against a substance over form argument attempting to recast a guarantee as a *loan* from the shareholder to the corporation. The more debt-equity principles show that the creditor looked primarily to the guarantor for repayment, the more they show that such a loan to the corporation should be recast as an equity contribution.[126] Paradoxically, arguments which seek to increase a sharholder's basis in an S corporation are best made in the context of stock-basis precedent. Even this precedent, however, is hostile.[127]

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123. *See supra* notes 114-15 and accompanying text.
124. Comment, *supra* note 6, at 1264.
125. *See id.*
126. *See supra* note 85.
127. It should be noted that the *Selfe* decision is the *only* recorded case to allow an increase in shareholder stock basis for a guarantee of a loan, and only under very limited facts. Moreover, the *Selfe* court did not actually decide the case on the facts: critical issues were still in dispute, and the case was remanded for further proceedings. *See supra* notes 96-103 and accompanying text.