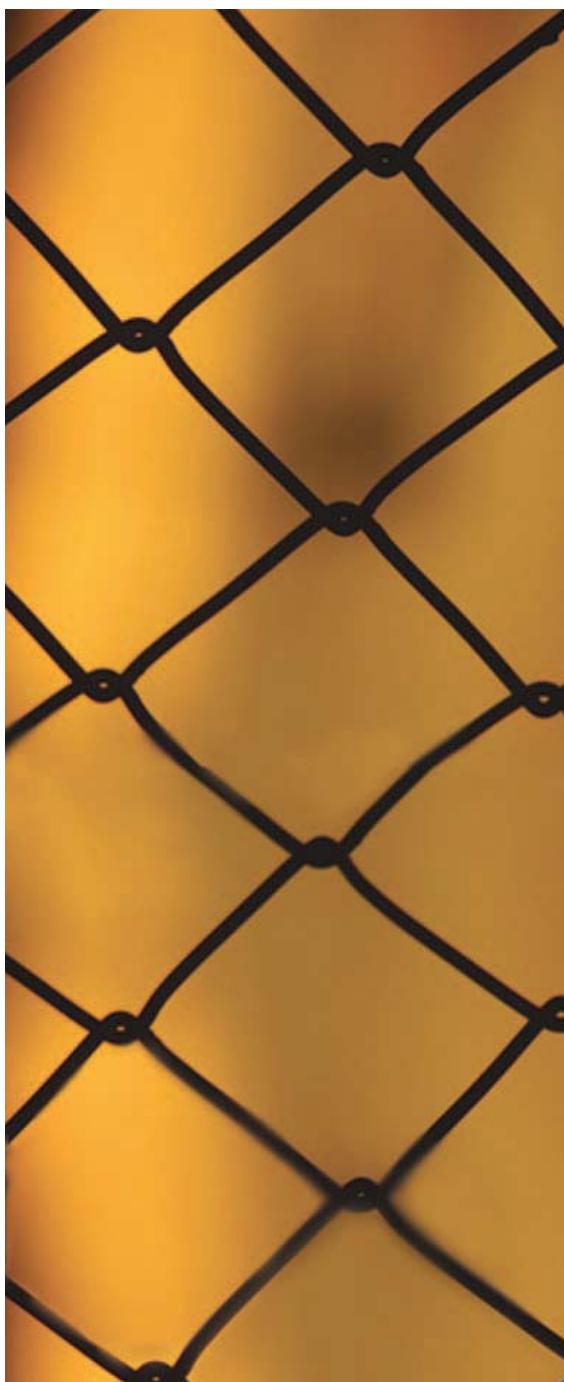


# Economic Outlay Revisited

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**T**he economic outlay doctrine is a judicially developed concept that acts like a barrier for S corporation shareholders attempting to create debt basis in their S corporations. The barrier is not impenetrable, but it requires analysis and forethought for the shareholders to break through.

Under Sec. 1366(d)(1), the deductibility of subchapter S losses is limited to the shareholder's stock and debt basis. If the corporation's current-year loss exceeds the shareholder's basis, Sec. 1366(d)(2) provides that this loss may be carried forward indefinitely. This carryforward provides some relief from a temporary lack of basis, but planning opportunities and pitfalls exist, particularly when shareholders own stock in multiple passthrough entities with varying degrees of profitability and the shareholders have varying degrees of basis in those entities.

Shareholders can create stock basis by making capital contributions; however, shareholders often prefer to create debt basis. To avoid expending their personal funds in a direct loan to an S corporation, shareholders have tried to create debt basis in a number of other ways, including: (1) guaranteeing the S corporation's note, (2) obtaining a loan from an unrelated or a related party and lending the loan proceeds to the S corporation (back-to-back loan), and (3) substituting a shareholder's personal note for the corporation's note to an unrelated third party. The IRS and the courts have used the economic outlay doctrine to analyze whether shareholders of S

corporations actually create debt basis. Briefly stated, that requires an actual cash investment by the shareholder. This article specifically focuses on how to create debt basis and how to structure debt so that it meets the economic outlay doctrine.

**Note:** The IRS has put a back-to-back loan project on its current business plan.

It is important to note that the economic outlay concept does not appear to apply to the creation of stock basis. Therefore, in many of the economic outlay cases, legal issues aside, if the S corporation had issued stock instead of debt, the taxpayer would have been successful in creating basis. In situations involving a single S corporation, the fact that personally guaranteed third-party debt does not establish debt basis usually complicates the question of the existence of debt basis. Since it has long been established that guarantees do not create basis, this article does not cover those cases.<sup>1</sup> However, it does discuss the various ways shareholders have tried to establish debt basis through back-to-back loans or loan restructurings where a shareholder replaces the shareholder's note for the corporation's note. Multiple-entity environments provide the opportunity to engage

*Authors' note:* This article follows up on a September 2001 article that addressed how to restructure debt in light of the first economic outlay cases. See Porcaro, "Restructuring Debt Basis in Light of the 'Economic Outlay' Doctrine," 32 *The Tax Adviser* 604 (September 2001).

<sup>1</sup> See, e.g., *Underwood*, 535 F.2d 309 (5th Cir. 1976), aff'g 63 T.C. 468 (1975); *Estate of Bean*, 268 F.3d 553 (8th Cir. 2001); *Reser*, 112 F.3d 1258 (5th Cir. 1997); *Estate of Leavitt*, 875 F.2d 420 (4th Cir. 1989); and *Maloof*, 456 F.3d 645 (6th Cir. 2006).

in complex inter-entity transactions in an attempt to increase basis in a loss-generating S corporation. It is these scenarios that make up the factual backdrop for the economic outlay cases and rulings covered here.

### Economic Outlay: Background

The Tax Court first developed the economic outlay doctrine in *Perry*,<sup>2</sup> where an S corporation shareholder attempted to create basis through the issuance of notes between him and the corporation. In *Perry*, the shareholder issued a demand note to the S corporation in exchange for a long-term note of the same amount. The court concluded that these transactions amounted to little more than the posting of offsetting book entries. The court interpreted the economic outlay doctrine to require the shareholder to make an actual cash investment in the corporation. Since the court found no outlay of cash, the shareholder had no basis in the note.

Likewise, in *Underwood*,<sup>3</sup> the Tax Court concluded (and the Fifth Circuit affirmed) that no basis is created when a shareholder exchanges demand notes with his or her wholly owned corporations. The court considered the lack of an actual advance of funds by the shareholder and questioned the shareholder's intent to demand repayment. One shareholder controlled both entities; perhaps the result would have been different had the shareholder not been in control. A shareholder can create debt basis by borrowing money personally from an unrelated third party, which is then loaned to the corporation to pay off an existing corporate debt, provided the corporation is thereby released from liability (a back-to-back loan).<sup>4</sup>

Three factors should be considered when using the debt-substitution method of creating basis:

- The shareholder and the corporation should abide by the form of the transaction they have chosen—the corporation should not continue to make payments to the third-party lender;

- The corporation and the shareholder should execute a note; and
- If corporate assets must be used as security for the substituted loan, the corporation should pledge its assets to the shareholder, who then reassigns the security interest to the third-party lender.

### Interpretation of Statute

Courts derived the economic outlay concept in part due to a narrow interpretation of Sec. 1366(d)(1)(B), which refers to debt basis as “the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder” (emphasis added). Courts have interpreted this phrase to mean that the debt must run directly from the shareholder to the S corporation. On the surface this means that debt basis is not attributed to a shareholder when the S corporation receives a loan from a controlled entity. However, with the exception of a situation like that in the *Culnen* case,<sup>5</sup> the direct indebtedness requirement will render many attempts to restructure a shareholder's debt basis among related entities futile.

*Culnen* is an anomaly because the court found that payments made by a 100% owned S corporation to a second S corporation on the shareholder's behalf constituted direct debt from the shareholder to the second S corporation. The conclusion in *Culnen* may be different because the parties always accounted for the payments as loans from the first S corporation to the shareholder and loans from the shareholder to the second S corporation. Another factor that helped the shareholder in this case was that he made actual payments to the first S corporation to pay off the debt.

The rest of this article examines recent court cases relating to economic outlay. The exhibit at the end of the article provides a list of the most important factors a shareholder should consider in determining economic outlay.

## EXECUTIVE SUMMARY

- Under the economic outlay doctrine, to obtain basis in an S corporation with respect to debt, a shareholder must make an actual economic outlay, the outlay must somehow leave the shareholder poorer in a material sense, and the debt created must run directly between the shareholder and the S corporation.
- If an entity related to an S corporation shareholder transfers funds to the S corporation, the transfer may be treated as a loan from the shareholder if the related entity is treated as the “incorporated pocketbook” of the shareholder.
- The IRS will often use a substance-over-form argument in asserting that an economic outlay did not occur in a transaction. Courts will disallow basis increases for circular transactions in which the shareholder ends up in the same financial position that he or she started out in.
- Although courts carefully scrutinize back-to-back loan transactions, a taxpayer will be allowed to increase his or her debt basis for such a transaction if it is properly executed and documented.

2 *Perry*, 54 T.C. 1293 (1970).

3 *Underwood*, 63 T.C. 468 (1975), aff'd, 535 F.2d 309 (5th Cir. 1976).

4 See Rev. Rul. 75-144, 1975-1 C.B. 277; and *Gilday*, T.C. Memo. 1982-242; but see *Spencer*,

110 T.C. 62 (1998) (no debt basis created where there was no direct indebtedness between S corporation and taxpayer in a back-to-back loan situation).

5 *Culnen*, T.C. Memo. 2000-139.

## Substance over Form

In *Grojean*,<sup>6</sup> the taxpayer, a CPA, purchased a trucking company for \$13.9 million, funded with \$11 million in bank financing. The financing was structured to include a \$1.2 million loan directly to the taxpayer, who in turn used the loan proceeds to purchase a participation interest (i.e., a share) in the loan from the bank. The participation agreement subordinated the shareholder's interest to the bank's. The terms of the notes were identical, and loan payments were made electronically between the company and the bank, including the taxpayer's participation loan. The corporation did not execute a note with the taxpayer, and the company's financial statements referred to the taxpayer as a guarantor. The Tax Court and the Seventh Circuit both concluded that the corporation was not directly indebted to the taxpayer and that the participation interest was nothing more than a disguised personal guaranty, so no debt basis was created.

## Planning Points

- The fact that the transaction is structured in advance and for a nontax business purpose (limited liability) may not create basis.
- The way a transaction is reported on financial statements may be considered.
- Taxpayers cannot apply the substance-over-form<sup>7</sup> doctrine to support their position.

## Document Everything

The facts in the *Cox* case<sup>8</sup> are not complicated or unusual. Three shareholders of an S corporation that was generating operating losses tried to create debt basis via two loans that originated from a third-party lender. For the first loan for \$220,000, one of the shareholders borrowed the money from the bank. The shareholder used approximately \$72,000 of the loan proceeds for personal purposes and loaned the rest to the S corporation to fund its operations.

Initially, the shareholders argued that each of them should be able to increase their debt basis by one-third of the total \$220,000 loan, even though only one shareholder owed the debt. There was no support in the law to allow for a basis increase in this case. As an alternative approach, the shareholder who owed the debt proved, based on primarily oral testimony, that \$148,000 of the loan proceeds was directly advanced to the S corporation and that therefore his basis should be increased by that amount. The court agreed with that position due to actual advance of funds, citing *Goatcher*,<sup>9</sup> *Estate of Leavitt*,<sup>10</sup> and *Guerrero*.<sup>11</sup> The second loan, for \$70,000, was a basic corporate loan secured by personal residences and personally guaranteed by the shareholders, which did not create basis for the purpose of Sec 1366(d). The end result was that only one shareholder created basis in debt and only for the amount (\$148,000) that was actually loaned to the S corporation. In addition, the court upheld accuracy-related penalties under Secs. 6662(a) and (b) assessed against the taxpayers.

## Planning Points

- Keep detailed records to support direct loans to the S corporation, particularly if the shareholder is using other property as collateral.
- In order for personally guaranteed debt to constitute basis, the shareholder must personally make payments on the loan.<sup>12</sup>

## Invisible Basis

*Estate of Bean*<sup>13</sup> was interesting because the taxpayers tried almost everything to make it appear that they had basis in their S corporation. Originally, the taxpayers operated a trucking business as a partnership but reported it for income tax purposes as a sole proprietorship. Later, they set up another trucking company as an S corporation. The taxpayers operated both companies (the partnership and the S corporation) for a period of time. In 1992,

the partnership sold all its assets to the S corporation, except a \$284,618 receivable from the S corporation, in exchange for the assumption of liabilities. No gain or loss was recognized.

The taxpayers attempted to establish that they had basis in three different ways. First, they tried to convince the court to give them credit for the purported equity in the assets that they sold to the S corporation. Second, they stated that they should be able to increase their debt basis by the amount of the S corporation's \$284,618 outstanding debt to the partnership. Finally, the taxpayers took the position that the use of personal property to secure a corporate bank loan should constitute economic outlay.

The Tax Court concluded, and the Fifth Circuit concurred, that none of the arguments resulted in the creation of debt basis. The intercompany asset sale did not establish basis because the transaction took place between the partnership and the S corporation, and not the partners, so there was no direct indebtedness. In addition, since they had structured the transaction to avoid the recognition of gain, the taxpayers could not prove that there was any equity in the assets. The courts concluded that the amount due to the partnership could not be attributed to the partners; therefore, they could not increase their debt basis in the S corporation.

This conclusion is troublesome because the facts of the case seem to indicate that the partners had dissolved the partnership in 1992 after the asset sale, but the Fifth Circuit stated that no evidence was presented that the receivable was distributed to the partners, who in turn contributed it to the S corporation. It is not clear what other conclusion could be reached regarding the disposition of the intercompany payable. However, the court noted that for financial statement purposes the corporation referred to the liability as an amount due to an affiliate, not to the officers. The use of personal property to

6 *Grojean*, 248 F.3d 572 (7th Cir. 2001), aff'g T.C. Memo. 1999-425.

7 *Court Holding Co.*, 324 U.S. 331 (1945).

8 *Cox*, T.C. Memo. 2001-196.

9 *Goatcher*, 944 F.2d 747 (10th Cir. 1991).

10 *Estate of Leavitt*, 875 F.2d 420 (4th Cir. 1989), aff'g 90 T.C. 206 (1988).

11 *Guerrero*, T.C. Memo. 2001-44.

12 *Raynor*, 50 T.C. 762 (1968).

13 *Estate of Bean*, 268 F.3d 553 (8th Cir. 2001).

secure a corporate bank loan did not create basis because no direct indebtedness was created under Sec. 1366(d)(1)(B) and no economic outlay occurred.<sup>14</sup> The court also cited the *Calcutt* case,<sup>15</sup> in which the Tax Court concluded that the at-risk rules under Sec. 465 would also prohibit an increase in basis due to the use of personal property as collateral for a corporate loan.

### Planning Points

- Structuring a transaction to achieve one objective (minimizing recognition of gain) may have an offsetting adverse tax effect (no basis created).
- Document the liquidation and transfer of an intercompany loan.
- The manner in which a transaction is reported on financial statements may be considered.
- Consider the application of the at-risk rules.

### The Shell Game

The *Thomas* case<sup>16</sup> evolved out of the audit of a refund claim resulting from the carryback of net operating losses generated by an S corporation. During the exam, the IRS determined that the taxpayer's basis in the S corporation included numerous transactions involving multiple related entities and a related bank over a two-year period. In each instance, the loan originated with a transfer of funds from or through a related entity and was reclassified after the fact as a loan or paid-in capital from the taxpayer. The Tax Court provided a detailed analysis of each transaction and concluded that no economic outlay had occurred and therefore no basis was created in any of the transactions. The Eleventh Circuit agreed with the Tax Court's decision.

For several of the transactions, the taxpayer asserted that the related entities advanced funds as an agent of the taxpayer. His arguments did not persuade the courts, apparently because of the inconsistent accounting treatment. It is important to note that the taxpayer successfully

argued the agent-principal theory in the *Culnen* case referred to earlier but not in the *Thomas* case.

In another transaction, the taxpayer attempted to document a loan from an entity as a loan from himself by relying on an executed promissory note that predated the actual loan. The court found the taxpayer's argument to be an unsupported after-the-fact rationalization, and it did not allow him to increase his basis.

### Planning Points

- Take care to consider the tax implications of a capital advance to an S corporation before completing it. Do not take shortcuts.
- The way a transaction is reported on financial statements may be considered.

### Circular Loans

The *Oren* case<sup>17</sup> involved a taxpayer who owned and controlled multiple S corporations involved in the trucking business. In order to establish basis under Sec. 1366, the taxpayer tried to employ the "back-to-back-to-back" loan technique. Each transaction involved an identical loan from profitable Corporation A to Oren, who loaned the funds to loss Corporation B, which in turn loaned the funds back to A, all on the same day. The corporations and Oren properly documented each loan with a note, but the note was unsecured and allowed for a lengthy repayment period after demand was made. Interest was paid, but in the same circular fashion as the loans.

The courts concluded that the loans did not constitute an economic outlay, so no basis was created. In addition, the court concluded that the structure of the transaction eliminated any "realistic possibility of loss,"<sup>18</sup> so the taxpayer was not at risk for the borrowed funds under Sec. 465(b)(4). Oren contended that the loans significantly affected his economic wealth and that the court should respect the form of the transaction in determining whether a direct loan existed between the

S corporation and the shareholder. Citing the *Bergman* case,<sup>19</sup> the court stated that an economic outlay and a direct loan arrangement are required to establish basis.

This case had one interesting twist. In 1996, the taxpayer converted the outstanding debt to capital and filed a protective refund claim in case the issue was lost for the 1993–1995 tax years. It is not clear from the record if this strategy was successful.

In the *Kaplan* case,<sup>20</sup> the taxpayer conducted his business through multiple entities that included several S corporations, one of which operated at a loss while the others were profitable. In a circular transaction, the shareholder borrowed money from a bank in December. The loan was collateralized by two bank deposit accounts owned by two separate profitable S corporations that the taxpayer owned. At the time of the loan, the bank accounts each had a zero balance.

On the same day, the taxpayer advanced to the loss S corporation an amount equal to the bank loan, and the loss S corporation paid the advance from Kaplan to the two profitable S corporations. The amount paid to one of the profitable S corporations was just an advance. The payment to the other profitable S corporation was in satisfaction of a payable the loss company owed. In January of the next year, the shareholder paid off the bank loan. In another December transaction, the loss S corporation made an adjusting entry to reallocate funds it received from another profitable venture owned by Kaplan to a loan from Kaplan.

The court determined that the purported loan from Kaplan to the loss S corporation involved no actual economic outlay. In this case, the court decided the various disbursements were "the equivalent of offsetting bookkeeping entries, even though they occurred in the form of checks." The loan proceeds originated and ended with the bank. The loan was collateralized with money that the profitable S corporations deposited in accounts

14 Citing *Harris*, 902 F.2d 445 (5th Cir. 1990).

15 *Calcutt*, 84 T.C. 716 (1985).

16 *Thomas*, T.C. Memo. 2002-108, aff'd, No. 02-13565 (11th Cir. 2003).

17 *Oren*, T.C. Memo. 2002-172, aff'd, 357 F.3d 854 (8th Cir. 2004).

18 *Young*, 926 F.2d 1083 (11th Cir. 1991).

19 *Bergman*, 174 F.3d 928 (8th Cir. 1999).

20 *Kaplan*, T.C. Memo. 2005-218.

## In *Miller*, the shareholder made an economic outlay by becoming the full recourse obligor on an enforceable debt held by an unrelated third party.

with the bank. In effect, the bank loan proceeds constituted the collateral for the bank loan. Based on the records, the loan proceeds never left the bank.

When examining the second December transaction, the court noted that merely adjusting journal entries among the shareholder's various wholly owned S corporations is inadequate to establish that the shareholder had made an actual economic outlay. There was no indication in this instance that the profitable S corporation was relieved of any liability. Thus, the court concluded that neither transaction created basis for the shareholder.

### Planning Points

- Taxpayers cannot rely solely on the form of the transaction.
- The way a transaction is reported on financial statements may be considered.
- Consider the application of the at-risk rules.
- All transactions should not be consummated on the same day.
- The terms of the note must be commercially reasonable.

### Timing Is Everything

The taxpayers in the *Ruckriegel* case<sup>21</sup> equally owned an S corporation that operated several fast-food franchises and a partnership that owned and leased real estate. The case is important because it specifically addresses the structure and documentation of direct and indirect back-to-back loans.

In the wake of a prior tax audit that resulted in the denial of passthrough losses due to the lack of basis, the taxpayers'

CPA consulted with the IRS agent on how to structure loans to create basis and advised his clients accordingly. Based on the facts of the case, the court categorized the numerous loans made to the S corporation into two types: indirect and direct loans. The indirect loans went from a related entity to the S corporation but were accounted for as loans from the shareholders. The direct loans went from a related entity to the shareholders, who in turn loaned the money to the S corporation.

The loans did not involve a circular transaction as in the *Oren* case. The shareholders took specific steps to document each transaction. Promissory notes, corporate minutes, and authorizations were executed, and each entity's books and records were adjusted to be consistent with the documentation, but not in a timely manner. In many cases the notes predated the actual loan.

The court found that the taxpayers' failure to document and record the indirect loans contemporaneously with the actual financial transaction resulted in the loans' not being attributed to the shareholders. The taxpayers argued that the related entities were "incorporated pocketbooks" and that the indirect loans should therefore constitute an economic outlay, as in *Culnen*<sup>22</sup> and *Yates*.<sup>23</sup> Though the court confirmed its conclusion that the related entities in those cases were incorporated pocketbooks, it differentiated the case at hand because the number of checks written (31) by the related entity on behalf of the shareholders was not enough to support the incorporated pocketbook theory.

The court defined the term "incorporated pocketbook" to describe a taxpayer's habitual practice of having its wholly owned corporation (or other entity) pay money to third parties on the taxpayer's behalf. The court concluded that the money the shareholder borrowed from the related entities and loaned directly to the S corporation did constitute an economic outlay that created basis, despite the fact that the court did not give any evidentiary weight to the promissory notes or other documents and the loan payments were made by the S corporation. In short, the form of the loan was given greater weight than the substance. Neither the IRS nor the court considered the possible application of the at-risk rules.

### Planning Points

- Avoid indirect loans from a related entity.
- Prepare all documentation and adjusting entries at the time of the loan.
- Involve the shareholder in the documentation of the loans in order to demonstrate intent.
- Prepare and file Form 1099-INT, Interest Income.

### The Transaction Game

In *PK Ventures*,<sup>24</sup> individual shareholders owned 100% of one S corporation (SLPC) and an interest in another corporation (TPC). SLPC became insolvent. SLPC was indebted to TPC and TPC was indebted to the individual shareholders. For two years the individual shareholders paid part of the amount that SLPC owed TPC by reducing the amount TPC owed them. These transactions were recorded on the companies' books by journal entries. No cash actually changed hands. The taxpayer contended that the debt he purportedly paid for SLPC gave him basis in his SLPC interest. The IRS disagreed, concluding that the shareholder did not have an actual economic outlay and that the debt was not direct debt.

After considering all the facts in the case, the court concluded that the only intended economic effect of these transactions was

<sup>21</sup> *Ruckriegel*, T.C. Memo. 2006-78.

<sup>22</sup> *Culnen*, T.C. Memo. 2000-139.

<sup>23</sup> *Yates*, T.C. Memo. 2001-280.

<sup>24</sup> *PK Ventures, Inc.*, T.C. Memo. 2006-36.

to enable the shareholders to deduct losses from SLPC that they would not have otherwise been able to deduct. At the time of the transactions, no party advanced or received any funds. Instead, the transactions consisted of offsetting book entries. The court found no evidence to indicate that a bona fide debt existed between TPC and the shareholder prior to these transactions. The court was also not convinced that SLPC ever paid the shareholder any of the amounts it was purported to owe the shareholder after these transactions. Therefore, the court decided that the transactions when fully completed did not leave the shareholder poorer in a material sense, so the shareholder did not make an actual economic outlay and the transactions did not create basis in debt for the shareholders.

### Planning Points

- Avoid indirect loans from a related entity.
- All adjusting entries must have substance to them.

### The Taxpayer Can Win

In *Miller*,<sup>25</sup> the taxpayer owned an S corporation, which had originally obtained financing from a bank. The shareholder guaranteed the original debt. Several years later, the shareholder restructured the loan so that the bank reissued the debt to the shareholder personally. The shareholder then made a cash contribution to the S corporation, which the corporation used to repay its loan to the bank. The shareholder made a collateral assignment to the bank of all the shareholder's rights under the security agreement the S corporation gave to the shareholder for the line of credit between them. Subsequently, the shareholder borrowed additional funds from the bank and immediately loaned those funds to the S corporation.

The court ruled that the note substitution amounted to a constructive furnishing of the taxpayer's funds to the corporation, and the back-to-back loans created a direct debt from the S corporation to the shareholder. Although

### Exhibit: Ten important factors to consider when structuring back-to-back loans

1. In order for there to be an economic outlay, the shareholder must experience a risk of an actual decrease in wealth.
2. The taxpayer must originally structure the transaction as a loan and must properly document the transaction. All documentation and adjusting entries should be prepared at the time of the loan. The shareholder should be involved in the documentation of the loans in order to demonstrate intent from the beginning. The way an entity reports a transaction on its financial statements may be considered, so a loan needs to be recorded as such from the start. In addition, shareholders should remember that structuring a transaction to achieve one objective, such as minimizing the recognition of gain, may have an offsetting adverse tax effect, such as no basis created.
3. The loan must be bona fide debt. It needs to be legally enforceable and state the amount due, the interest rate, and the payment schedule. A market interest rate is not mandatory but is one indication that a loan is a bona fide debt. Cash should change hands in the transaction.
4. Use of an unrelated party is preferable. Indirect loans from a related entity should be avoided if possible. As shown in the *Miller* case, loans made from an unrelated party to the shareholder and then lent to the S corporation generally create basis.
5. Transactions should not be circular. It is best to make the loan directly from the shareholder. Using multiple entities in a transaction does not create basis when the intent to create debt does not exist. The IRS can use the step-transaction doctrine to link separate transactions.
6. Taxpayers cannot apply the substance-over-form doctrine to support their position. As courts have pointed out repeatedly, because taxpayers choose the form of the transaction originally, they cannot assert the substance-over-form doctrine to try to recharacterize the transaction.
7. A shareholder should keep detailed contemporaneous records to support direct loans to the S corporation, particularly if the shareholder is using other property as collateral. The more detailed the records, the better.
8. In order for personally guaranteed debt to constitute basis, the shareholder must personally make payments on the loan.<sup>26</sup> Thus, the shareholder actually needs to write the checks to make payments on the loans. Mere journal entries are not enough.
9. In a multi-part transaction, not all the parts of the transaction should be consummated on the same day. This behavior tends to imply that the shareholder had no economic outlay. If possible, it may be helpful if the back-to-back loans are not for the same amount.
10. The at-risk rules of Sec. 465 should be considered. Showing that a taxpayer is at risk with respect to a debt under Sec. 465 helps prove that the shareholder has basis in the debt.

the shareholder obtained promissory notes from the S corporation and then assigned them to the lender, the assignment was only a collateral assignment of a security interest under state law and

the corporation remained liable to the shareholder. Therefore, the shareholder was deemed to have made an economic outlay that left him poorer in a material sense by becoming the full recourse

<sup>25</sup> *Miller*, T.C. Memo. 2006-125.

<sup>26</sup> *Raynor*, 50 T.C. 762 (1968).

obligor on an enforceable debt that was held by an unrelated third-party lender. By relending the proceeds from the loan to the S corporation, the shareholder created a direct debt that increased his basis in the S corporation and allowed him to deduct losses against that basis.

### Conclusion

The existence of an economic outlay by a taxpayer is a fact that the tax practitioner and the taxpayer must be prepared to demonstrate in order to create debt basis in an S corporation. The exhibit on p. 297 contains a list of the 10 key factors distilled from the various cases that a tax practitioner must consider when evaluating whether a shareholder has established economic outlay for purposes of creating debt basis. Shareholders and tax practitioners should exercise due caution when setting up back-to-back loans. (The IRS recently added this issue to its business plan.) However, as seen from the *Miller* case, if a transaction is structured correctly, a taxpayer can prevail when the IRS challenges a transaction based on the economic outlay requirement.

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### EditorNotes

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