

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of	)	
	)	DOCKET NO. 23902
[Redacted],	)	
	)	
Petitioners.	)	DECISION
_____	)	

[Redacted] (petitioners) protest the Notice of Deficiency Determination (NODD) issued by the auditor for the Idaho State Tax Commission (Commission) dated February 4, 2011, asserting additional liabilities for Idaho income tax and interest in the total amounts of \$2,904, \$2,147, and \$1,859 for 2007, 2008, and 2009, respectively.

The petitioners owned [Redacted], an S corporation. The corporation had losses in each of the years in question. Shareholders in an S corporation may deduct their proportionate share of the losses of an S corporation to the extent of their basis in the stock and debt of the S corporation. Internal Revenue Code § 1366(d)(1)(A). The sole question to be resolved in this docket is the petitioners' debt basis in the debt of the corporation. The auditor calculated the petitioners' basis in the debt to be less than did the petitioners. Therefore, the auditor reduced the amount of the losses from the corporation that were deductible by the petitioners. The petitioners appealed.

The debt in question was comprised of several notes from [Redacted]. Each such loan listed both the corporation and the petitioners as "borrowers." The balance sheets which were a part of the income tax returns filed by the corporation reflected "Mortgages, notes, bonds payable in 1 year or more" in amounts ranging from \$464,620 (at the beginning of 2007) to \$421,681 (at the end of 2009). These same balance sheets reflected "Loans to shareholders" in

amounts ranging from \$186,684 (at the beginning of 2007) to \$171,988 (at the end of 2009). No loans from the shareholders to the corporation appeared on any of the balance sheets.

The auditor determined that, based upon the record, the debt in question did not provide the petitioners with additional debt basis in the corporation. Accordingly, she disallowed the losses claimed by the petitioners.

The petitioners contend that the loans were to them and that they, in turn, loaned funds to the corporation. They stated that they provided personal financial information and balance sheets to the bank and the Small Business Administration. They stated that the corporation had no net worth while the petitioners had a substantial net worth. They stated that the term of the loan was such that it was related to real estate and that they, and not the corporation, owned real property. They stated that the loan was collateralized by the real property owned by the petitioners and that there was a “due on sale” clause in the loan documents which would require the repayment of the entire loan if the petitioners’ real property were to be sold. The petitioners also contend that their position is supported by the “LESSOR’S AGREEMENT” which states that the “Borrower [the petitioners] obtained or will obtain a loan . . . from Lender in the amount of \$440,000.” The petitioners cited no authority to support their position.

The petitioners contend that the loans were made to the petitioners as evidenced by the 1098s issued by [Redacted] having been issued to the petitioners and not to the corporation. The petitioners also do not agree with the auditor’s statement that the corporation deducted the interest expense on the loans. On this latter point, the petitioners contend that the interest deducted by the corporation was on the loans from the petitioners to the corporation. When looking at the balance sheets from the returns filed by the corporation, however, we find no loans from the shareholders to the corporation, but find instead loans from the corporation to the

petitioners. Therefore, it appears that the contention of the petitioners that there were loans from the petitioners to the corporation is without support in the accounting records of the corporation.

The Commission finds that the Tax Court has addressed substantially identical circumstances:

Under section 1366, S corporation shareholders may deduct their pro rata share of losses and deductions of the S corporation. The deductions, however, are limited to the sum of the adjusted basis of the shareholders' stock in the corporation, sec. 1366(d)(1)(A), and the adjusted basis of any indebtedness of the corporation to the shareholders, sec. 1366(d)(1)(B).

Petitioners contend that they were primary obligors under the loans and that Bank One looked primarily to Mr. Hafiz and to his personal assets for repayment. Petitioners argue that the loans at issue should be viewed as loans to petitioners, followed by a loan from petitioners to Family Motels for the same amount. Petitioners assert that they are entitled to increase their bases in the indebtedness of the corporation to them by the amount of the loans. In the alternative, petitioners argue that they should be entitled to increase their bases in the indebtedness of Family Motels by a portion [footnote omitted] of the loans. Respondent contends that because petitioners did not make any payments under the loans, petitioners are not entitled to increase their bases.

To increase the basis in the indebtedness of an S corporation, there must be an economic outlay on the part of the shareholder. Estate of Leavitt v. Commissioner, 875 F.2d 420, 422 (4th Cir.1989), affg. 90 T.C. 206 (1988); Brown v. Commissioner, 706 F.2d 755, 756 (6th Cir.1983), affg. T.C. Memo.1981-608.[footnote omitted] The economic outlay required under section 1366(d)(1)(B) must leave “the [taxpayers] poorer in a material sense.” Perry v. Commissioner, 54 T.C. 1293, 1296 (1970), affd. per order (8th Cir.1971) (quoting Horne v. Commissioner, 5 T.C. 250, 254 (1945)). Although a bona fide loan from a shareholder to an S corporation will increase the shareholder's basis, the shareholder must make an actual economic outlay and directly incur the indebtedness. Underwood v. Commissioner, 63 T.C. 468, 476 (1975), affd. 535 F.2d 309 (5th Cir.1976). As was noted by this Court in Raynor v. Commissioner, 50 T.C. 762, 770-771 (1968):

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. Prior to that crucial act, “liability” may exist, but not debt to the shareholders.

The shareholders must make actual disbursements on the indebtedness before they can augment their bases for the purpose of deducting losses. Estate of Leavitt v.

Commissioner, supra at 422. Since petitioners have not made actual disbursements on the loans, they are not entitled to increase their bases.

Petitioners argue that we should ignore the form of the loans and rely on the economic substance in deciding whether the loans were actually made to petitioners. We find that the form and substance of the transaction was a loan from the bank to Family Motels. The proceeds of the loan were to be used to purchase the motels on behalf of the corporation. Petitioners submitted no evidence that they were free to dispose of the proceeds of the loans as they wished. Nor were the payments on the loans reported as constructive dividends in the corporation's income tax returns or on petitioners' income tax returns during the years in issue. Family Motels made all of the loan payments to the bank and deducted the interest paid on the loans.

Hafiz v. Commissioner, T. C. Memo 1998-104.

In another decision, the Tax Court stated, in part:

Petitioners' argument is the same as that presented to the Court in William H. Perry, 47 T.C. 159 (1966), affd. 392 F.2d 458 (C.A. 8, 1968), and Joe E. Borg, 50 T.C. 257 (1968). As was noted in Borg, the fact that 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. Prior to that crucial act, 'liability' may exist, but not debt to the shareholders. See Gilman v. Commissioner, 53 F.2d 47, 50 (C.A. 8, 1931); Joe E. Borg, supra, and cases cited therein.

Raynor v. Commissioner, 50 T.C. 762, 770-771 (1968).

What we have here is simply the comaking of the notes in question. The Commission finds that the authority clearly and uniformly denies additional basis under these circumstances.

THEREFORE, the Notice of Deficiency Determination dated February 4, 2011, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioners pay the following tax and interest (computed to August 31, 2011):

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
2007	\$2,502	\$442	\$2,944
2008	1,958	218	2,175
2009	1,777	111	<u>1,888</u>
		TOTAL DUE	<u>\$7,107</u>

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the petitioners' right to appeal this decision is enclosed.

DATED this \_\_\_\_\_ day of \_\_\_\_\_ 2011.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_ 2011, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.

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