

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

In the Matter of the Protest of	)	
	)	DOCKET NO. 24245
[Redacted],	)	
	)	
Petitioners.	)	DECISION
_____	)	

[Redacted] (Taxpayers) protested a Notice of Deficiency Determination (NODD) issued by the Idaho State Tax Commission (Commission) on May 13, 2011. In taxable year 2009, Taxpayers deducted net operating loss for taxable year 2007. The net operating loss was passed through from [Redacted]. The Income Tax Audit Bureau determined Taxpayers did not have sufficient basis in the corporation to deduct the entire loss deduction. Due to the basis limitation, the net operating loss carryback was disallowed.

The Commission received Taxpayer’s protest on July 11, 2011. Taxpayers requested an informal teleconference which was held on December 6, 2011. After hearing Taxpayers’ position at the informal teleconference and having reviewed the file, the Commission is prepared to issue its decision on the issues presented.

**BACKGROUND FACTS**

In November 2004, Taxpayers and two other couples purchased three parcels of land in [Redacted]. In 2006, the owners began operating as [Redacted], an Idaho partnership. Each of the couples owned an equal one-third interest in [Redacted]. The partners transferred the parcels of land to [Redacted]. The cost basis of the land, according to [Redacted] balance sheet, amounted to \$780,487, which included the purchase price of \$620,000 and other capitalized costs.

In 2005, Taxpayers and the other partners of [Redacted] an Idaho S-corporation. The partners owned [Redacted] as equal one-third shareholders.

In January 2007, [Redacted] sold the parcels of land to [Redacted]. Of the \$[Redacted] reported the sale of the land and the receipt of the note on its 2007 tax return under the installment method.

Taxpayers asserted the transaction between [Redacted] occurred between related parties for purposes of the Internal Revenue Code (IRC); thus Taxpayers argue [Redacted] debt basis in the installment note must be limited by the basis in the land as held by the partnership and reduced by any recaptured basis. Additionally, Taxpayers argue the partnership must be treated as an aggregate of its partners in their individual capacities. Thus, according to Taxpayers, the installment note held by the partnership is an obligation of [Redacted] by the partners in their individual capacity and therefore the debt running from the S corporation runs directly to the shareholders.

## ANALYSIS

### **1. Internal Revenue Code § 1366 and Debt Basis in the Installment Note**

Under IRC §1366(d)(1)(B), shareholders of an S corporation may deduct losses up to the amount of the shareholder's adjusted basis of the S corporation's indebtedness that runs directly to the shareholder. Unlike a partner in a partnership, a shareholder's basis in an S corporation does not include entity level debt unless the debt is a loan from the shareholder to the corporation.<sup>1</sup> The issue at hand is whether the installment note from [Redacted] qualifies as indebtedness from the S corporation to its shareholders.

In order for the shareholder to have basis in debt, the shareholder must have made an actual economic outlay and the debt must run directly from the corporation to the shareholder.<sup>2</sup> The economic outlay must "leave the taxpayer poorer in a material sense in order for its bona fides to be respected."<sup>3</sup> There must be an actual cost to the taxpayer in order for there to be an economic outlay. There is no economic outlay when shareholders guarantee loans when shareholders do not incur any actual costs.<sup>4</sup> Also, transactions involving "circular flow[s] of funds (beginning and ending with the original lender) designed solely to generate bases in an S corporation have no economic substance and therefore do not evidence the required economic outlay."<sup>5</sup>

Additionally, the debt must run directly from the shareholder to the S corporation in order for the shareholder to have basis in the debt. A debt obligation of an S corporation running to a partnership does not create indebtedness of the corporation to the shareholders.<sup>6</sup> Moreover, "[a]n

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<sup>1</sup> IRC 1367(b)(2)

<sup>2</sup> Id.; Miller v. C.I.C., T.C.M. (RIA) 2006-125 (T.C. 2006)

<sup>3</sup> Miller v. C.I.C., T.C.M. (RIA) 2006-125 (T.C. 2006)

<sup>4</sup> Bean v. C.I.R., U.S. Tax Ct. 2000

<sup>5</sup> Kerzner v. Comm'r of Internal Revenue, 97 T.C.M. (CCH) 1375 (T.C. 2009)

<sup>6</sup> Id.; Frankel v. Commissioner, 61 T.C. 343 (1973), affd.

[S] corporation's indebtedness to an entity in which its shareholders have substantial or even identical ownership interests does not constitute an indebtedness of the corporation to the shareholders."<sup>7</sup>

In the present case, the facts presented show that [Redacted] owns the installment note given by [Redacted]. The shareholders of [Redacted] did not provide any economic outlay regarding the transaction between [Redacted] sufficient to provide debt basis in [Redacted]. The facts show the partners of [Redacted] incurred economic outlay with the original purchase of the parcels of land in 2004. However, this is accounted for within the partnership and not within the S corporation. Furthermore, Taxpayers failed to present any evidence that the debt actually runs between [Redacted] and the shareholders. Rather, the facts tend to prove the debt runs directly between [Redacted].

## **2. [Redacted] Must be Treated as a Separate Entity**

Taxpayers asserted at the informal conference that [Redacted] was a "default partnership" and the installment note should be treated as if owned by the partner's in their individual capacity.

Idaho's uniform partnership laws state that a partnership will be created where two or more persons carry-on a business as co-owners for profit.<sup>8</sup> Where the formation of a partnership is in dispute, it will depend on a factual analysis of the parties' intent to form a partnership. The facts presented by Taxpayers demonstrate the parties intended to form a partnership. The partners contributed land to [Redacted]. [Redacted] maintained its own accounts, filed its own federal and state returns, and obtained its own Employer Identification Number. In all communications between Taxpayers and the Commission, Taxpayers held [Redacted] out to be a

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<sup>7</sup> Burnstein v. Commissioner, T.C. Memo. 1984-74, Shebester v. C.I.R., 53 T.C. Memo 1987-246

<sup>8</sup> Idaho Code § 53-3-202(a).

<sup>8</sup> Idaho Code § 53-3-202(a).

legal entity.

Furthermore, for tax purposes, Idaho Code § 63-3006B defines partnerships to include any entity classified as a partnership under Internal Revenue Code § 7701. Under the IRC, entities will be classified as an entity separate from its owners if such entity meets certain requirements. “A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom.”<sup>9</sup> The United States Supreme Court also held that a partnership is created “when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and then there is community of interest in the profits and losses.”<sup>10</sup> In other words, where the partners carry on a business for shared profit, it will create a valid partnership. Taxpayers and the other partners of [Redacted] to carry on business activities for profit which they intended to split equally. [Redacted] was a legitimate partnership for all purposes.

Generally “a taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business ... he must accept the tax disadvantages” associated with his choice of entity.<sup>11</sup> Taxpayers and the other partners of [Redacted] chose to operate as a partnership. The position proposed by Taxpayers overlooks the partnership as an entity and as the vehicle chosen by the partners to facilitate their business operations. In this situation, the Commission may not ignore the form chosen by Taxpayer. Thus, the Commission cannot find that the installment note owned by [Redacted] is instead owned by the partners in their individual capacity. To do so would lack any purpose other than to provide Taxpayers an impermissible tax benefit.

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<sup>9</sup> 26 C.F.R. § 301.7701-1

<sup>10</sup> Commissioner v. Tower, 327 U.S. 280, 286 (1946); as cited in Commissioner v. Culbertson, 337 U.S. 733 (1949).

<sup>11</sup> Higgins v. Smith, 308 U.S. 473, 477, 60 S. Ct. 355, 358, 84 L. Ed. 406 (1940)

**CONCLUSION**

The Commission finds the installment note failed to create debt basis for the shareholders in [Redacted]. The shareholders did not have an actual economic outlay in the note. Additionally, the debt did not run directly from [Redacted] to its shareholders. For these reasons, the Commission affirms the NODD in its entirety.

THEREFORE, the NODD dated May 13, 2011, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED that Taxpayers pay the following tax and interest:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2007	\$4,110	\$0	\$872	\$4,982

Interest for the above deficiency is calculated through July 20, 2012.

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

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

DATED this \_\_\_\_\_ day of \_\_\_\_\_ 2012.

IDAHO STATE TAX COMMISSION

\_\_\_\_\_  
COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_ 2012, 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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