

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)
[Redacted],) DOCKET NO. 26198
Petitioners.)
DECISION
_____)

BACKGROUND

On December 19, 2013, the Audit Bureau (Audit) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) to [Redacted] (Petitioners) disallowing a refund request for taxable year 2010 in the amount of \$4,955.

The Petitioners filed an amended Idaho income tax return for taxable year 2010 based on a net operating loss carry back from taxable year 2012. Audit reviewed the request for a refund and disallowed the loss carry back because of a lack of basis in the S corp.

At the end of 2012, the S corp. issued a promissory note to the Petitioner in an amount that equaled the total of all the credit card debt, the outstanding balance on the line of credit, the amount loaned from the Petitioners' other company, and some funds that were distributed from another company owned by the Petitioners. Audit reviewed the support for the note and found that \$28,506.52 represented funds that were deposited by the Petitioners. Audit issued a modified NODD on December 30, 2013, allowing that amount as stock basis. That increase in the 2012 basis was not enough to create a Net Operating Loss (NOL) to carry back to taxable year 2010.

On February 20, 2014, the Petitioner filed a timely protest. On March 21, 2014, the file was transferred to the Legal/Tax Policy Division for resolution.

ISSUES

1. Whether the balance of a credit reserve line in the Petitioners' son's name, used for the benefit of the business, adds to the Petitioners' debt basis.
2. Whether using personal credit cards with the company name adds to the debt basis of the Petitioners in their wholly owned S corporation¹ (S corp.).
3. Whether money that was loaned to the S corp. by another company that is wholly owned by the Petitioners adds to the Petitioners' debt basis.

DISCUSSION

A meeting was held at the Boise office of the Commission on July 8, 2015, to discuss the issues. This was not considered an informal hearing, but a chance to discuss what is necessary to establish debt basis and allow the Petitioners to gather evidence that would help their position. It was agreed that this would be more efficient than to schedule a hearing. No additional information has been provided during the appeal. The Commission makes this decision with the information in the file.

Issue 1. Whether the balance of a credit reserve line in the Petitioners' son's name, used for the benefit of the business, adds to the Petitioners' debt basis.

A shareholder that is liable for debt outside the S corp. does not create debt basis until that debt is actually paid. This has become known as the "Economic Outlay Doctrine" and repeated by the Tax Court in several cases². The Commission has addressed this in prior decisions. This quote is from Docket No. 24245.

¹Under federal law, S corporations permit shareholders to elect a pass-through taxation system under which income is subjected to only one level of taxation; the corporation's profits pass through directly to its shareholders on a pro rata basis and are reported on the shareholders' individual tax returns. Internal Revenue Code, subchapter S.

²Bergman v. U.S. AFTR 2d 99-1882, Estate of Alton Bean v. Comm. 88 AFTR 2d 2001-6111, Oren v. Comm. 93 AFTR 2d 2004-858 and Maloof v. Comm. 98 AFTR 2d 2006-5832.

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.³ 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 shareholder⁴. The economic outlay must "leave the taxpayer poorer in a material sense in order for its bona fides to be respected⁵." 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 costs⁶. 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.⁷

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.⁶ Moreover, "[a]n [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.⁸

Issue 2. Whether using personal credit cards with the company name adds to the debt basis of the Petitioners in their wholly owned S corp. This issue is similar to the first one. All three of these issues are essentially governed by the same legal principle. The information provided to prove the deposits to the company that increased the stock basis included check registers. The check registers show that it was the company that was making the credit card payments and not the Petitioners.

³ IRC 1367(b)(2).

⁴ Id.; Miller v. C.I.C., T.C.M. (RIA) 2006-125 (T.C. 2006)

⁵ Miller v. C.I.C., T.C.M. (RIA) 2006-125 (T.C. 2006)

⁶ Bean v. C.I.R., U.S.Tax Ct. 2000

⁷ Kerzner v. Comm'r of Internal Revenue, 97 T.C.M. (CCH) 1375 (T.C. 2009)

⁸ Id.; Frankel v. Commissioner, 61 T.C. 343 (1973), affd.

Issue 3. Whether money that was loaned to the S corp. by another company that is wholly owned by the Petitioners adds to the Petitioners' debt basis. This issue has been decided by the Tax Court numerous times and is in the quote above from Docket No. 24245. In Morris G. Underwood v Commissioner⁹ Internal Revenue, the court determined that a note issued by an S corp. to the owners to replace other debt does not increase debt basis in the corporation. The note issued by the S corp. to the Petitioners, after the fact, does not increase the debt basis. The Commission agrees with audit disallowing the NOL in excess of the stock and debt basis.

THEREFORE, the NODD dated December 19, 2013, modified December 30, 2013, and directed to [Redacted] and [Redacted] is hereby AFFIRMED.

<u>YEAR</u>	<u>REFUND CLAIMED</u>	<u>REFUND ALLOWED</u>	<u>TOTAL</u>
12/31/10	(\$4,955)	\$0	\$0
12/31/12	0	0	<u>0</u>
		BALANCE DUE	<u>\$0</u>

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

DATED this _____ day of _____ 2015.

IDAHO STATE TAX COMMISSION

COMMISSIONER

⁹ 63 TC 468.

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2015, 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.
