

**Income Tax II**  
**Bogdanski**  
**Spring 2024**

**Problem Set 1**

*Problem 1.1.* Individuals A and B both are and will continue to be in the highest marginal individual tax bracket. They are forming a business that they expect will generate deductible losses of about \$300,000 over the next three years and then will turn around and generate income of about \$100,000 per year indefinitely. A and B each will “materially participate” in the operation of the business. What form(s) of business organization will produce the most favorable tax results for A and B?

*Problem 1.2.* Three individuals, R, S, and T, form a limited liability company. Each of the three are equal members of the LLC. How will the LLC be classified for federal income tax purposes, with and without available tax elections?

*Problem 1.3.* Unless otherwise indicated, Z Corporation (“Z”) is a domestic corporation that has 115 shares of voting common stock outstanding. In each of the following alternative situations, determine whether Z is eligible to elect S corporation status:

- (a) Z has 99 unrelated individual shareholders, each of whom owns one share of Z stock. The remaining 16 shares are owned by A and his brother, B, as joint tenants with right of survivorship.
- (b) Same as (a), above, except that A and B are married to each other and own 10 of the 16 shares as community property. The remaining 6 shares are owned 3 by A as her separate property and 3 by B as his separate property.
- (c) In (b) above, assume that the shareholders of Z elected S corporation status. What will be the effect on Z’s election if one year later A dies and bequeaths her interest in Z stock to her unrelated butler, X?
- (d) Same as (a), above, except that the remaining 16 shares are held by a nonprofit corporation that operates a private high school.
- (e) Same as (a), above, except that the remaining 16 shares are held by an irrevocable inter vivos trust that has three related beneficiaries. The trustee is given the power to decide which of the beneficiaries receive the income from the trust. All of the beneficiaries are individuals, and the grantor of the trust retains no interest in it whatsoever. What if the beneficiaries were unrelated to each other and to any of the other shareholders?
- (f) Same as (a), above, except that the remaining 16 shares are owned by a revocable trust created by an individual, the income of which is taxed to the grantor under I.R.C. § 671.
- (g) Same as (a), above, except that the remaining 16 shares are owned by a testamentary trust under which the surviving spouse has the right to income for her life, with the remainder passing to her children. The trust is a “qualified terminable interest trust” (see IRC § 2056(b)(7)).

- (h) One of Z's 115 outstanding shares is owned by a C corporation.
- (i) Ninety of Z's 115 outstanding shares are owned by an S corporation.
- (j) All of Z's 115 outstanding shares are owned by an S corporation.
- (k) All of Z's 115 outstanding shares are owned by a partnership.
- (l) Z has 100 shares of Class A voting common stock and 50 shares of Class B nonvoting common stock outstanding. Apart from the differences in voting rights, the two classes of common stock have equal rights with regard to dividends and liquidation distributions. Z also has an authorized but unissued class of nonvoting stock that would be limited and preferred as to dividends. The Class A common stock is owned by four individuals, and the Class B common stock is owned by E and F (a married couple) as tenants-in-common.
- (m) All of Z's outstanding shares are held by an individual. Among other things, Z owns a .001% stock interest in Microsoft, a publicly traded corporation; 80% of the stock of a privately held corporation, Privco; and 100% of the stock of another corporation, Subco. Can Privco elect to be an S corporation? Can Subco?

*Problem 1.4.* X is a "small business corporation" that has been operating for several years as a C corporation. X uses the calendar year for its taxable year. When is its S election effective if it is duly filed –

- (a) On March 2, 2024?
- (b) On March 22, 2024?

*Problem 1.5.* Y, a "small business corporation," is formed, and begins its first taxable year, on September 1, 2023. Its taxable year is the calendar year. When is its S election effective if it is duly filed –

- (a) On September 1, 2023?
- (b) On November 10, 2023?
- (c) On November 22, 2023?
- (d) On March 2, 2024?
- (e) On March 22, 2024?

*Problem 1.6.* How is a corporation's status as an S corporation terminated? When is a termination of S status effective? Can S status be retroactively reinstated after a termination?

### **Study Materials for Problem Set 1**

IRC §§ 11, 199A, 701, 1361, 1362, 1363, 1366, 7701(a)(3), 7704.

Treas. Regs. §§ 1.1362-6, 301.7701-1, 301.7701-2, 301.7701-3.

## Problem Set 2

In each case, assume that X is a business entity with three equal owners, R, S, and T. R, S, and T each contribute \$10,000 cash to X to form the entity.

What are the tax consequences to X, R, S, and T of each of the following fact patterns? For R, S, and T, consider the effects on the basis of their ownership interests as well as the amount, character and timing of any income they have. In each case, address each of the following scenarios:

*Scenario A.* X is a C corporation.

*Scenario B.* X is an S corporation.

*Scenario C.* X is a partnership, or an LLC taxed as a partnership.

*Problem 2.1.* For the first year of its operation, X has a pre-tax operating profit (and taxable income) of \$15,000. On the last day of the year, X pays R, S, and T a distribution on equity (that is, a dividend in Scenarios A and B, a partnership distribution in Scenario C) of \$2,500 each. What if X's taxable income was all long-term capital gain?

*Problem 2.2.* Same as Problem 2.1, except that the distributions to R, S, and T are \$5,000 each.

*Problem 2.3.* Same as Problem 2.1, except that the distributions to R, S, and T are \$8,000 each.

*Problem 2.4.* Same as Problem 2.1, except that X makes no distributions on its equity; however, it distributes \$5,000 of its pre-tax income to each of R, S, and T as compensation for personal services.

*Problem 2.5.* For the first year of its operation, X has a pre-tax operating loss of \$15,000.

*Problem 2.6.* For its first year, X's gross income and deductions from operations happen to offset each other exactly. At the end of the year, X distributes Blackacre, a parcel of real estate, one-third each to R, S, and T as tenants in common. The distribution is on equity (that is, a distribution with respect to stock in Scenarios A and B, a partnership distribution in Scenario C). The fair market value of Blackacre at the time of the distribution is \$15,000; assume that the value received by the three owners is \$5,000 each. X's adjusted basis in Blackacre (which it purchased from a third party a few months earlier) immediately before the distribution is \$12,000. (Consider what R, S, and T's basis in Blackacre is.)

### Study Materials for Problem Set 2

*Scenario A (C corporations):* I.R.C. §§ 11, 162(a)(1), 172, 301, 311, 312, 316(a), 317(a).

*Scenario B (S corporations):* I.R.C. §§ 1363, 1366, 1367, 1368, 1371.

*Scenario C (partnerships):* I.R.C. §§ 701, 702, 704, 705, 707(a), 707(c), 731, 732, 733.

### Problem Set 3

In each case, assume that X is a business entity with three equal owners, R, S, and T. R, S, and T each contribute \$10,000 cash to X to form the entity.

What are the tax consequences to X, R, S, and T of each of the following fact patterns? For R, S, and T, consider the effects on the basis of their ownership interests as well as the amount, character and timing of any income they have. In each case, address *each* of the following scenarios:

*Scenario A.* X is a C corporation.

*Scenario B.* X is an S corporation.

*Scenario C.* X is a partnership, or an LLC taxed as a partnership. Under the partnership agreement or LLC operating agreement, all items of income, deduction, loss and credit are allocated equally among R, S, and T.

*In this problem set, we will first discuss all of the problems together as applied to C corporations. We will then discuss all of the problems together in the context of S corporations; finally, we will discuss all of the problems together in the context of partnerships.*

*Problem 3.1.* Shortly after it is formed, X borrows \$54,000 from a bank. The loan is a recourse loan; no payments are due until the next year. For the first year of its operation, X has a pre-tax net operating loss of \$39,000. X makes no distributions to R, S, or T. For purposes of Scenario C, assume that X is a general partnership.

*Problem 3.2.* Same as Problem 3.1, except that, in Scenario C, X is a limited partnership; R is the sole general partner; and S and T are the limited partners.

*Problem 3.3.* Same as Problem 3.1, except that, in Scenario C, X is an LLC.

*Problem 3.4.* Same as Problem 3.2, except that R, S, and T individually guarantee X's obligation to the lender. For purposes of Scenario C, assume that X is a limited partnership; R is the sole general partner; and S and T are the limited partners.

*Problem 3.5.* Same as Problem 3.1, except that, in addition to contributing \$10,000 each in cash for their equity interests in X, the owners (R, S, and T) each lend \$10,000 to X.

*Problem 3.6.* Same as Problem 3.1, except that for the first year of its operations, X has a pre-tax operating profit (before any deduction for interest it paid) of \$24,000. X pays \$900 of interest and \$1200 of principal to the lender.

### Study Materials for Problem Set 3

*Scenario A (C corporations):* I.R.C. §§ 11, 172.

*Scenario B (S corporations):* I.R.C. §§ 1363, 1366 (especially 1366(d)), 1367, 1371; *Harris v. United States* (below).

*Scenario C (partnerships):* I.R.C. §§ 702, 704 (especially 704(d)), 705, 752; Treas. Regs. §§ 1.752-1(a), 1.752-2(a), (b), 1.752-3.

(902 F.2d 439)

**J.H. HARRIS, and William J. Martin, Plaintiffs-Appellants,  
v.  
UNITED STATES of America, Defendant-Appellee.**

United States Court of Appeals,  
Fifth Circuit.

June 7, 1990.

Appeal from the United States District Court for the Eastern District of Louisiana.

Before JOHNSON, WILLIAMS and GARWOOD, Circuit Judges.

GARWOOD, Circuit Judge:

In this federal income tax refund suit, plaintiffs-appellants, J.H. Harris (Harris) and William J. Martin (Martin), collectively Taxpayers, appeal the district court's summary judgment in favor of defendant-appellee, the United States (Government). We affirm.

**Facts and Proceedings Below**

In June 1982, Taxpayers contracted with Trans-Lux New Orleans Corporation to purchase for \$665,585 cash a New Orleans pornographic theater that they intended to convert into a wedding hall. The Taxpayers' obligations under the contract were conditioned on their being able to secure from a third party a loan for not less than \$600,000 repayable in fifteen to twenty years.<sup>1</sup> Shortly before this time, Taxpayers had contacted John Smith (Smith), a real estate loan officer with Hibernia National Bank (Hibernia), to discuss the possibility of obtaining financing for the impending acquisition. Smith orally committed to lend Taxpayers \$700,000.<sup>2</sup>

Subsequently, to shield themselves from the potential adverse publicity that could follow from the purchase of the pornographic theater, as well as to limit their personal liability and enhance their chances of qualifying for industrial revenue bonds to finance the theater's renovation, in July 1982 Taxpayers formed Harmar (Harmar), a Louisiana corporation, which elected to be taxed pursuant to Subchapter S of the Internal Revenue Code, to purchase and operate the subject property. Harris and Martin each initially contributed \$1,000 to the corporation, receiving its stock in return, and each also loaned Harmar \$47,500 to satisfy operating expenses. Harris and Martin were the sole shareholders of Harmar, each owning half of its stock.

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<sup>1</sup> As part of the contract, Taxpayers deposited with the seller \$32,500, all of which was to be applied to the purchase price. In the event Taxpayers were unable to procure the loan, the purchase contract called for their deposit to be refunded.

<sup>2</sup> Smith asserted in his deposition that he did not know the purpose of the borrowed funds in excess of the purchase price, but he surmised that the money was intended for improvements to the theater. No written loan commitment was ever issued.

The purchase of the theater closed on November 1, 1982, and the theater was conveyed to Harmor on that date. Hibernia furnished the \$700,000 necessary to close the transaction.<sup>3</sup> In borrowing the funds necessary to acquire the subject property, Harmor executed two promissory notes payable to Hibernia for \$350,000 each, each dated November 1, 1982. One of these notes was secured by a \$50,322.09 Hibernia certificate of deposit in Harris' name and another \$304,972.49 certificate of deposit in the name of his wholly-owned corporation, Harris Mortgage Corporation. Harmor secured the other note, in accordance with its collateral pledge agreement, by its \$3,000,000 note (which was unfunded apart from the \$700,000) and its collateral mortgage on the theater, each executed by Harmor in favor of Hibernia and dated November 1, 1982. Under the terms of the collateral pledge agreement executed by Harmor in reference to the \$3,000,000 note and mortgage, the mortgage secured "not only" Harmor's \$350,000 note to Hibernia, "but also any and every other debts, liabilities and obligations" (other than consumer credit debt) of Harmor to Hibernia whether "due or to become due, or whether such debts, liabilities and obligations" of Harmor "are now existing or will arise in the future." Thus, the collateral mortgage secured the full \$700,000 loan from Hibernia. Additionally, Taxpayers each executed personal continuing guarantees of Harmor indebtedness in the amount of \$700,000 in favor of Hibernia. Smith testified in his deposition that the transaction was structured so that half the loan, as represented by one of the \$350,000 notes, would be primarily secured by the certificates of deposit and the other half, represented by the other \$350,000 note, primarily by the mortgage on the property purchased, with the entire amount also secured by Taxpayers' individual guarantees.

On its income tax return for the year ending December 31, 1982, Harmor reported a net operating loss of \$104,013. Pursuant to section 1374 of the Internal Revenue Code of 1954,<sup>4</sup> Taxpayers each claimed half of the loss as a deduction on their 1982 individual returns,<sup>5</sup> concluding that their bases in Harmor were in fact greater than Harmor's net operating loss for that year and that they therefore were entitled to deduct the entire loss on their personal returns. On audit, the Internal Revenue Service (IRS) found to the contrary and determined that Harris and Martin each had a basis of \$1,000 in his Harmor stock and an adjusted basis in Harmor's indebtedness to each of them as shareholders of \$47,500. Pursuant to [former] I.R.C. § 1374(c)(2) [now I.R.C. § 1366(d)(1)], the IRS limited Taxpayers' deductions of the net operating loss to what it considered to be their bases in Harmor, \$48,500 each. The IRS's disallowance of a portion of the deductions claimed by Taxpayers<sup>6</sup> resulted in additional tax liability, including interest, for Martin of \$3,150.58 and for Harris of \$1,280. Taxpayers paid the tax in dispute and now appeal the district court's summary judgment dismissing their suit for refund.

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<sup>3</sup> As noted, the purchase price was \$665,585. Harris testified in his deposition that at closing there was also paid some \$10,000 in miscellaneous closing costs and a \$35,000 real estate commission, so "the entire \$700,000 was accounted for at the closing." It is unclear whether the \$32,500 escrow previously deposited by the Taxpayers with the seller was wholly or partially refunded to them or was credited to Harmor. Harmor's 1982 income tax return shows that as of December 31, 1982, it had land and buildings with an original cost of \$674,367.

<sup>4</sup> Except as otherwise indicated, references herein to the Internal Revenue Code (I.R.C.) are to the Internal Revenue Code of 1954. \* \* \* We also observe that the limitations provided in former § 1374(c)(2) by section 2 of the Subchapter S Revision Act of 1982 were subsequently reenacted in § 1366(d)(1). That section is currently in effect.

<sup>5</sup> Harris and Martin claimed deductions for Harmor's loss of \$52,006 and \$52,007, respectively.

<sup>6</sup> The IRS disallowed \$4,506 of Harris' deduction and \$4,507 of Martin's.



## Discussion

Taxpayers contend on appeal that in determining the deduction allowable for Harmar's net operating loss, the IRS should have included in Taxpayers' bases in their Harmar stock the full value of the \$700,000 Hibernia loan they guaranteed. I.R.C. § 1374 permits a Subchapter S shareholder to deduct from his personal return a proportionate share of his corporation's net operating loss to the extent that the loss does not exceed the sum of the adjusted basis of his Subchapter S corporation stock and any corporate indebtedness to him. See section 1374(c)(2) (now section 1366(d)(1)). To arrive at their basis figure, Taxpayers seek to recast the transaction in question. They in essence urge that we disregard the form of the Hibernia loan – one from Hibernia to Harmar – in favor of what Taxpayers consider as the substance of the transaction – a \$700,000 loan from Hibernia to them, the \$700,000 proceeds of which they then equally contributed to Harmar's capital account. As evidence of their view of the substance of the transaction, Taxpayers point to the deposition testimony of Smith indicating that Hibernia looked primarily to Taxpayers, rather than to Harmar, for repayment of the loan, and they call attention to the \$700,000 guarantees they each provided Hibernia as well as the \$355,294.58 in certificates of deposit that Harris pledged to Hibernia as part of the November 1, 1982 loan transaction.

In its summary judgment memorandum, the district court declared that *Brown v. Commissioner*, 706 F.2d 755 (6th Cir.1983), was “on all fours” with the instant case and therefore resolved it. In *Brown*, the Sixth Circuit rejected shareholders' substance over form argument in ruling that the shareholders' guarantees of loans to their Subchapter S corporation could not increase their bases in their stock in the corporation unless the shareholders made an economic outlay by satisfying at least a portion of the guaranteed debt. *Id.* at 757. Without such an outlay, the *Brown* court concluded that “the substance matched the form” of the transaction before it. *Id.* at 756. The reasoning of *Brown* was followed by the Fourth Circuit in *Estate of Leavitt v. Commissioner*, 875 F.2d 420 (4th Cir.1989), *aff'g*, 90 T.C. 206 (1988). There, the court, affirming the en banc Tax Court, held that shareholder guarantees of a loan to a Subchapter S corporation did not increase shareholders' stock basis because such guarantees had not “cost” shareholders anything and thus did not constitute an economic outlay. *Leavitt*, 875 F.2d at 422 & n.9.<sup>7</sup> In reaching this conclusion, the Fourth Circuit affirmed as not clearly erroneous a finding of the Tax Court that the loan, in form as well as in substance, was made to the corporation rather than to the shareholders.<sup>8</sup> *Id.* at 424. The court rejected appellants' suggestion that it employ the debt/equity principles espoused in *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir.1972), in determining whether the shareholders had actually made an economic outlay,<sup>9</sup> instead choosing to employ a debt/equity

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<sup>7</sup> In reasoning that the shareholders had not increased their stock bases as a result of their guarantees, the court turned to I.R.C. § 1012, which defines basis of property as its cost. *Id.* at 422 n.9. Cost of property, in turn, is defined in the Treasury Regulations as the “amount paid for such property in cash or other property.” 26 C.F.R. § 1.1012-1(a).

<sup>8</sup> The court noted that the loan in question had been made by the bank directly to the corporation, the loan payments were made by the corporation directly to the bank, and neither the corporation nor the shareholders reported the payments as constructive dividends. *Id.*

Under *Leavitt*, the presumption is that the form will control and that presumption will not be surmounted absent the shareholder's satisfying the higher standard applicable to a taxpayer's seeking to disavow the form he selected and recast a transaction. See Bowers, *Building Up an S Shareholder's Basis through Loans and Acquisitions*, J. Tax'n S Corp., Fall 1989, at 22, 29.

<sup>9</sup> In *Plantation Patterns*, this Court considered whether a Subchapter C corporation could deduct interest payments made on its debt and whether its shareholders had resulting dividend income. The Court, using a

analysis only after making a finding that an economic outlay had occurred.<sup>10</sup> *Leavitt*, 875 F.2d at 427. The *Leavitt* court reasoned that the legislative history of section 1374 limiting the basis of a Subchapter S shareholder to his corporate investment or outlay could not be circumvented through the use of debt/equity principles.<sup>11</sup> *Id.* at 426 & n.16. See generally Bogdanski, *Shareholder Guarantees, Interest Deductions, and S Corporation Stock Basis: The Problems with Putnam*, 13 J. Corp. Tax'n 264, 268-89 (1986).

Taxpayers press this Court to follow the contrary holding of *Selfe v. United States*, 778 F.2d 769 (11th Cir.1985). There, the Eleventh Circuit ruled that a shareholder's guaranty of a Subchapter S corporation loan could result in an increase in equity or debt basis even though the shareholder had not satisfied any portion of the obligation. *Selfe*, 778 F.2d at 775. The court remanded the case to the district court for it to employ debt/equity principles in determining if the loan in question was in substance one to the shareholder rather than to the corporation. *Id.*

The courts have uniformly ruled that a shareholder must make an economic outlay to in-

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debt/equity analysis, affirmed a Tax Court finding that a corporation's interest payments on debentures were constructive dividends and could not be deducted as interest payments. *Id.* at 723-24.

Subsequent decisions have elaborated on *Plantation Patterns* and identified thirteen factors used to establish whether shareholder advances to a corporation are debt or equity. They are:

- “(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.”

*In re Lane*, 742 F.2d 1311, 1314-15 (11th Cir.1984) (quoting *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir.1972)).

<sup>10</sup> The Fourth Circuit embraced the Tax Court's interpretation of its earlier opinion in *Blum v. Commissioner*, 59 T.C. 436 (1972). In *Blum*, the court rejected the taxpayer's substance over form argument. The *Leavitt* Tax Court asserted that the *Blum* court never reached the debt/equity issue “because the taxpayer had failed his burden of proving that the bank in substance had loaned the funds to the taxpayer and not to the corporation.” *Leavitt*, 90 T.C. at 215. Thus construed, *Blum* in no way undermines the Fourth Circuit's § 1374 analysis.

<sup>11</sup> See S. Rep. No. 1983, 85th Cong., 2d Sess. at 220, U.S. Code Cong. & Admin. News 1958, p. 4791, (1958-3 Cum. Bull. at 1141); see also Comment, *Subchapter S Loss Limitation: The Effect of Shareholder Loan Guarantees on Basis*, 40 Sw. L.J. 1241, 1263 (1987).

crease his Subchapter S corporation stock basis. *See Leavitt*, 875 F.2d at 422; *Selfe*, 778 F.2d at 772; *Brown*, 706 F.2d at 756; *Underwood v. Commissioner*, 535 F.2d 309, 311-12 (5th Cir. 1976). Taxpayers assert that if we look beyond the form of the transaction at what they contend is its substance – a loan from Hibernia to them, which in turn they contributed to Harmar as capital – we must find that a \$700,000 outlay occurred and that their stock bases therefore correspondingly increased. They contend that use of debt/equity principles will lead us to such a conclusion.

Ordinarily, taxpayers are bound by the form of the transaction they have chosen; taxpayers may not in hindsight recast the transaction as one that they might have made in order to obtain tax advantages. *Don E. Williams Co. v. Commissioner*, 429 U.S. 569, 97 S.Ct. 850, 856-57, 51 L.Ed.2d 48 (1977); *C.I.R. v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 94 S.Ct. 2129, 2137, 40 L.Ed.2d 717 (1974). The IRS, however, often may disregard form and recharacterize a transaction by looking to its substance. *Higgins v. Smith*, 308 U.S. 473, 60 S.Ct. 355, 357, 84 L.Ed. 406 (1940). The Tax Court has recognized an exception to the rule that a taxpayer may not question a transaction's form in cases such as this one in which the shareholder argues that guaranteed corporate debt should be recast as an equity investment on the shareholder's part. *Blum v. Commissioner*, 59 T.C. 436, 440 (1972).

In this case we find that the transaction as structured did not lack adequate substance or reality and that an economic outlay justifying the basis claimed by Taxpayers never occurred.

The summary judgment evidence reflects that the parties to this transaction intended that the Hibernia loan be one to the corporation. Each of the two \$350,000 promissory notes was executed by and only in the name of Harmar. The notes have been renewed and remain in the same form, namely notes payable to Hibernia in which the sole maker is Harmar.<sup>12</sup> Hibernia, an independent party, in substance earmarked the loan proceeds for use in purchasing the subject property to which Harmar took title, Harmar contemporaneously giving Hibernia a mortgage to secure Harmar's debt to Hibernia. The bank sent interest due notices to Harmar, and all note payments were made by checks to Hibernia drawn on Harmar's corporate account.<sup>13</sup> Harmar's books and records for all years through the year ended December 31, 1985, prepared by its certified public accountant, reflect the \$700,000 loan simply as an indebtedness of Harmar to Hibernia. They do not in any way account for or reflect any of the \$700,000 as a capital contribution or loan by Taxpayers to Harmar, although they do reflect the \$1,000 capital contribution each Taxpayer made and Harmar's indebtedness to Taxpayers for the various cash advances Taxpayers made to it. The Harmar financial statements for the year ended December 31, 1986, are the first to show any contributed capital attributable to the Hibernia loan. Further, Hibernia's records showed Harmar as the "borrower" in respect to the \$700,000 loan and the renewals of it. Har-

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<sup>12</sup> In his deposition, when discussing the documentation required to make the loan, Smith stated that items such as the corporate certificate of good standing, corporate charter, and articles of incorporation were prerequisites to closing the loan because Hibernia needed to know that it was "dealing with a valid entity." Harris' deposition demonstrates that he intended the loan to be one to Harmar. He acknowledged there that his legal and tax consultants had advised him that it was to his advantage to have a corporation borrow the funds from Hibernia. Martin stated that he was aware that in signing the promissory notes on November 1, 1982, he was executing them on behalf of Harmar.

<sup>13</sup> To the extent Harmar did not have funds available, Taxpayers would deposit personal funds into Harmar's account, but the checks were always drawn on Harmar's checking account. These and other amounts advanced by Taxpayers to Harmar were carried on its books as part of its interest-bearing indebtedness to Taxpayers.

mar's 1982 tax return, which covered August 15 through December 31, 1982, indicates that Harmar deducted \$12,506 in interest expenses. Because only the Hibernia loan generated such expenses for that period, it is reasonably inferable that the deduction corresponded to that loan. The 1982 Harmar return showed no distribution to Taxpayers, as it should have if the \$700,000 Hibernia loan on which Harmar paid interest was a loan to the Taxpayers. Further, the return shows the only capital contributed as \$2,000 and the only loan from stockholders as \$68,000, but shows other indebtedness of \$675,000. In short, Harmar's 1982 income tax return is flatly inconsistent with Taxpayers' present position. Moreover, there is no indication that Taxpayers treated the loan as a personal one on their individual returns by reporting Harmar's interest payments to Hibernia as constructive dividend income. In sum, the parties' treatment of the transaction, from the time it was entered into and for years thereafter, has been wholly consistent with its unambiguous documentation and inconsistent with the way in which Taxpayers now seek to recast it. Hibernia was clearly an independent third party, and the real and bona fide, separate existence of Harmar is not challenged. The parties did what they intended to do, and the transaction as structured did not lack adequate reality or substance.<sup>14</sup>

Moreover, if the transaction is to be "recast," it is by no means clear that it should be recast in the form sought by Taxpayers, namely as a cash loan to them from Hibernia followed by their payment of the cash to Harmar as a contribution to its capital, and Harmar's then using the cash to purchase the building. Such recasting does not account for Hibernia's mortgage on the building. In any event, if the transaction is to be recast, why should it not be recast as a loan by Hibernia to Taxpayers, with the Taxpayers using the funds to themselves purchase the building, giving Hibernia a mortgage on the building to secure their debt to it, and then transferring the building, subject to the mortgage, to Harmar as a contribution to capital? Presumably in that situation Taxpayers' bases in their Harmar stock would be reduced by the amount of the debt secured by the mortgage under I.R.C. § 358(d). See *Wiebusch v. Commissioner*, 59 T.C. 777, *aff'd per curiam* "on the basis of the opinion of the Tax Court," *Wiebusch v. Commissioner*, 487 F.2d 515 (8th Cir.1973).<sup>15</sup> While section 358(d) likely does

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<sup>14</sup> This is unlike the situation in *Underwood*, 535 F.2d at 312 & n.2, where we allowed the IRS to disregard a note of the shareholders of the Subchapter S corporation to another of their wholly-owned corporations that was substituted for the Subchapter S corporation's note, because it was not shown that the shareholders there intended to or would ever "make a demand upon themselves ... for payment of their note." Here, Hibernia was clearly an independent third party (and it is those who structured the transaction, not the IRS, who seek to recast it).

We also observe that this case stands in contrast to those involving nominees or dummy corporations. In such instances, courts may look beyond the form of a transaction if it is clear that the corporation served no significant business activity and that the shareholders intended that the corporation serve only as a dummy for them. See, e.g., *Paymer v. Commissioner*, 150 F.2d 334, 337 (2d Cir.1945); B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 2.10 (1979). In this case, Taxpayers intended that Harmar conduct significant business activity, and they do not contend that Harmar's separate, corporate identity should be disregarded or that it was a mere sham.

We do not suggest that had the transaction been structured in a different manner it would have lacked adequate substance or reality, or that there was no way the transaction could have been structured to afford Taxpayers a further \$700,000 basis in Harmar under section 1374(c)(2) (now section 1366(d)(1)).

<sup>15</sup> See also Megaard, *No Stock Basis for Shareholder Guarantee of S Corporation Debt*, 15 J. Corp. Tax'n 340 (1989). Megaard explains that "[u]nder Section 358(d), the assumption by a corporation of its shareholder's debt is treated as money received which reduces the shareholder's basis in the stock." *Id.* at 349. *Cf. id.* at 350 ("Having the corporation's assets encumbered by the shareholder's personal debt runs the risk of a basis reduction under Section 358 should the Service argue that the transaction was a purchase by the shareholder of the ... assets followed by a contribution of the assets to the corporation subject to the debt.").

not affect stockholder basis in the debt of the Subchapter S corporation to the stockholder, Taxpayers have not sought to recast the transaction as a loan by Hibernia to them followed by their loan of the proceeds to Harmar; indeed even after Harmar's books were rearranged starting with the year ending December 31, 1986, the books do not show any indebtedness in this respect of Harmar to Taxpayers and do continue to show Harmar as owing the money in question to Hibernia. There is simply no evidence of Harmar indebtedness to Taxpayers in respect to these funds.

Taxpayers' guarantees and Harris' pledge of certificates of deposit do not undermine the intent of the parties that Harmar be the borrower in this transaction. It certainly is not difficult to fathom that a careful lender to a new, small, closely held corporation such as Harmar would seek personal guarantees from all of its shareholders. See Bogdanski, *supra*, at 269. Moreover, the wholly unperformed guarantees do not satisfy the requirement that an economic outlay be made before a corresponding increase in basis can occur. See generally *Underwood*, 535 F.2d at 312. In the same light, Harris' pledge to Hibernia of some \$355,000 in certificates of deposit of his (and Harris Mortgage Corporation) does not provide such an outlay.<sup>16</sup>

We conclude that the transaction must be treated as it purports to be and as the parties treated it – namely as a loan by Hibernia to Harmar, all payments on which through the relevant time have been made by Harmar to Hibernia. For any funds or other assets Taxpayers have actually provided to Harmar as loans or contributions, Taxpayers are, of course, entitled to basis additions as of the time such contributions or loans were furnished by them to Harmar, but they are not entitled to a 1982 basis addition for Hibernia's 1982 \$700,000 loan to Harmar, notwithstanding that it was also secured by Taxpayers' execution of guarantees and Harris' pledge to Hibernia of his and Harris Mortgage Corporation's certificates of deposit in the total face amount of some \$355,000.

## **Conclusion**

There was no genuine dispute as to any material fact necessary to sustain the Government's summary judgment motion. The district court's judgment is correct and it is therefore

AFFIRMED.

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<sup>16</sup> Taxpayers would have us, in effect, convert this pledge to Hibernia into a \$700,000 cash contribution made to Harmar by Taxpayers equally. But that did not happen. Taxpayers do not contend that the certificates of deposit were contributed to Harmar's capital.

## Problem Set 4

In each case, assume that X is a business entity being formed by three equal owners, R, S, and T. In the formation transaction, each owner receives his or her one-third ownership share - stock, partnership interests or LLC interests, as the case may be. Like stock, the partnership and LLC interests entitle each owner to a share of the capital of X as well as a share of its profits.

What are the tax consequences to X, R, S, and T of each of the following factpatterns? For R, S, and T, consider the basis of their ownership interests as well as the amount, character and timing of any income they have. In addition, consider the basis to X of any property it receives. In each case, address *each* of the following scenarios:

*Scenario A.* X is a C corporation.

*Scenario B.* X is an S corporation.

*Scenario C.* X is a partnership, or an LLC taxed as a partnership. Under the partnership agreement or LLC operating agreement, all items of income, deduction, loss and credit are allocated equally among R, S, and T.

*Problem 4.1.* R contributes \$10,000 cash; S contributes Blackacre, with a basis to S of \$3,500 and a fair market value of \$10,000; T contributes \$10,000 cash. S is not a real estate dealer.

*Problem 4.2.* Same as Problem 4.1, except that, about a year after the formation of X, X sells Blackacre to Y for \$12,500. The sale was not planned or contemplated prior to the organization of X.

*Problem 4.3.* Same as Problem 4.1, except that T contributes \$10,000 of future services.

*Problem 4.4.* Same as Problem 4.1, except that T contributes Whiteacre, with a basis to T of \$8,000 and a fair market value of \$25,000; Whiteacre is encumbered by a mortgage securing a recourse loan with an outstanding principal balance of \$15,000. X assumes the mortgage. In Scenario C, assume that X is a general partnership.

### Study Materials for Problem Set 4

*Scenario A (C corporations):* I.R.C. §§ 351, 357, 358, 362, 1032, 83.

*Scenario B (S corporations):* Same Code sections as Scenario A, plus I.R.C. §§ 1366, 1367.

*Scenario C (partnerships):* I.R.C. §§ 721, 722, 723, 752, 731, 704(c), 1061; Treas. Regs. §§ 1.752-2(a), (b); Rev. Proc. 93-27 (below).

**Rev. Proc. 93-27**  
**1993-2 C.B. 343**

SECTION 1. PURPOSE

This revenue procedure provides guidance on the treatment of the receipt of a partnership profits interest for services provided to or for the benefit of the partnership.

SEC. 2. DEFINITIONS

The following definitions apply for purposes of this revenue procedure.

.1 A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest.

.2 A profits interest is a partnership interest other than a capital interest.

SEC. 3. BACKGROUND

Under section 1.721-1(b)(1) of the Income Tax Regulations, the receipt of a partnership capital interest for services provided to or for the benefit of the partnership is taxable as compensation. On the other hand, the issue of whether the receipt of a partnership profits interest for services is taxable has been the subject of litigation. Most recently, in *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991), the Eighth Circuit in dictum suggested that the taxpayer's receipt of a partnership profits interest received for services was not taxable, but decided the case on valuation. Other courts have determined that in certain circumstances the receipt of a partnership profits interest for services is a taxable event under section 83 of the Internal Revenue Code. See, e.g., *Campbell v. Commissioner*, T.C.M. 1990-236, rev'd, 943 F.2d 815 (8th Cir. 1991); *St. John v. United States*, No. 82-1134 (C.D. Ill. Nov. 16, 1983). The courts have also found that typically the profits interest received has speculative or no determinable value at the time of receipt. See *Campbell*, 943 F.2d at 823; *St. John*. In *Diamond v. Commissioner*, 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974), however, the court assumed that the interest received by the taxpayer was a partnership profits interest and found the value of the interest was readily determinable. In that case, the interest was sold soon after receipt.

SEC. 4. APPLICATION

.01 Other than as provided below, if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the Internal Revenue Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership.

.02 This revenue procedure does not apply:

- (1) If the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;
- (2) If within two years of receipt, the partner disposes of the profits interest; or
- (3) If the profits interest is a limited partnership interest in a “publicly traded partnership” within the meaning of section 7704(b) of the Internal Revenue Code.

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## Problem Set 5

In each case, assume that X is a business entity owned by three individuals: R, S, and T. Each owner has a one-third ownership share – stock, partnership interests, or LLC interests, as the case may be. Each owner has been active in the management of X. Like stock, the partnership and LLC interests entitle each owner to a share of the capital of X as well as a share of its profits.

X's books reveal the following assets:

	<i>Adjusted Basis</i>	<i>Fair Market Value</i>
Cash	\$ 6,000	\$ 6,000
Land (investment)	9,000	15,000
Inventory	21,000	30,000
<i>Total</i>	<i>\$ 36,000</i>	<i>\$ 51,000</i>

In addition, X has a strong customer following, which it has cultivated over the years through advertising and other activities that have generated immediate business expense deductions.

X has outstanding a bank debt of \$21,000. It is the only liability of X.

P is a corporation that wishes to purchase X.

What are the tax consequences to X, R, S, T, *and* P of each of the following fact patterns? Consider the basis of each taxpayer's assets as well as the amount, character and timing of any income each taxpayer has. In each case, address *each* of the following scenarios:

*Scenario A.* X is a C corporation with substantial earnings and profits ("E&P"). Each shareholder's stock basis is \$5,000.

*Scenario B.* X is an S corporation that has been an S corporation all its life; therefore, it has no E&P. Each shareholder's stock basis is \$5,000.

*Scenario C.* X is a partnership, or an LLC taxed as a partnership. Under the partnership agreement or LLC operating agreement, all items of income, deduction, loss and credit are allocated equally among R, S, and T. The agreement's allocations have substantial economic effect. The \$21,000 bank debt is properly allocated one-third to each partner under the regulations under I.R.C. § 752. Each partner's basis in his or her partnership interest or LLC interest is \$12,000.

*In this problem set, we will first discuss all of the problems together as applied to C corporations. We will then discuss all of the problems together in the context of S corporations; finally, we will discuss all of the problems together in the context of partnerships.*

*Problem 5.1.* P buys R's, S's, and T's ownership interests for \$15,000 each.

*Problem 5.2.* P buys all of X's assets from X for \$45,000, plus the assumption of X's \$21,000 liability to the bank. X liquidates and dissolves, distributing \$15,000 in cash to each of R, S, and T.

*Problem 5.3.* X liquidates and dissolves, distributing its assets to R, S, and T as one-third tenants in common. R, S, and T assume the liability of X. R, S, and T immediately sell the former X assets to P for \$45,000 cash, plus P's assumption of the X liability.

### **Study Materials for Problem Set 5**

*Scenario A (C corporations):* I.R.C. §§ 331, 334(a), 336, 1001, 1060, 197.

*Scenario B (S corporations):* Same Code sections as Scenario A, plus I.R.C. §§ 1366, 1367.

*Scenario C (partnerships):* I.R.C. §§ 708, 731, 732, 741, 751(a), 1001, 1060, 197.

## Problem Set 6

At the end of year 1, X is a C corporation owned by three shareholders, R, S, and T. Each shareholder owns one third of the only class of stock of X. Each shareholder has a basis in his or her X stock of \$95,000. X has accumulated earnings and profits of \$150,000. It owns three assets: Blackacre, Whiteacre, and Lossacre. At the end of year 1, Blackacre has a fair market value of \$120,000 and an adjusted basis of \$30,000; Whiteacre has a fair market value of \$90,000 and an adjusted basis of \$75,000; and Lossacre has a fair market value of \$5,000 and an adjusted basis of \$35,000.

X makes an S election effective January 1 of year 2. January 1 is the first day of X's taxable year.

*Problem 6.1.* In year 2, X has taxable income of \$30,000 from operations. Immediately before the end of year 2, X distributes \$13,000 cash to each shareholder.

*Problem 6.2.* In year 3, X sells Blackacre for \$90,000 cash. X's other activities for the year are profitable.

*Problem 6.3.* In year 3, X sells Blackacre for \$150,000 cash. X's other activities for the year are profitable.

*Problem 6.4.* X retains Blackacre, but in year 7, X sells Whiteacre for \$120,000 cash. X's other activities for the year are also profitable.

*Problem 6.5.* In year 2, half of X's gross receipts are from rents and royalties.

### Study Materials for Problem Set 6

I.R.C. §§ 1362(d)(3), 1368(c), 1374–1375.