Subchapter S Loss Limitation: The Effect of Shareholder Loan Guarantees on Basis

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UPON incorporation of a small business, many shareholders elect taxation under the provisions of subchapter S of the Internal Revenue Code. The well-known, partnership-like provisions of subchapter S allow tax items of the S corporation to pass through to the shareholder, who then personally reports his or her pro rata share of the tax items. The obvious advantage of this pass-through of tax items is that the shareholder may immediately deduct on a personal tax return operating losses of the corporation that, absent the subchapter S election, would remain inside the corporation awaiting potential carryback to past taxable years or carryover to future years. In this respect, the pass-through provisions of subchapter S greatly appeal to shareholders seeking improvement in short-term cash flow. The Code, however, limits the pass-through of losses and deductions to the sum of the shareholder's adjusted tax basis in the S corporation stock and the shareholder's tax basis in the indebtedness of the S corporation to the shareholder. Shareholders, therefore, have a keen interest in generating sufficient basis in both of these items.

When an S corporation seeks financing, lenders frequently require that the corporate shareholders personally guarantee the corporate debt. Shareholders have long argued that such a guarantee serves to increase the shareholders' adjusted tax basis in the corporation, and thereby allows a larger pass-through of losses and deductions. Courts, however, have uniformly held that shareholder loan guarantees generate no additional basis in indebtedness of the corporation to the shareholder. A few decisions have stated that the guarantee might increase the basis of the shareholder's stock if the guar-
antee in substance constitutes a loan from the bank followed by a share-
holder contribution to the corporation's capital.\(^5\) In no cases, however, did
an S corporation shareholder prevail using this substance over form
argument.

In December 1985 the Eleventh Circuit decided a case that may have
changed the rules of the game. In \textit{Selfe v. United States}\(^6\) the court held that
a shareholder loan guarantee results in an increase in the basis of either the
stock or the indebtedness of the S corporation to the shareholder upon a
factual determination that the lender looked primarily to the shareholder for
repayment.\(^7\) After explaining the legal background of the subchapter S op-
erating loss limitation and case law dealing with shareholder loan guaran-
tees, this Comment discusses \textit{Selfe} and the issues raised in that case. This
Comment then argues in favor of allowing an increased basis in an S corpo-
ration when shareholders personally guarantee corporate debt, if certain
conditions are met. Finally, this Comment proposes an amendment to the
Internal Revenue Code that would allow S corporation shareholders to in-
tcrease their basis in the corporation when they personally guarantee corpo-
rate debt.

\section{I. LIMITATION ON THE PASS-THROUGH OF LOSSES AND DEDUCTIONS}

Many small business corporations elect taxation under the provisions
of subchapter S of the Code in order to obtain a pass-through of tax items from
the corporation to the shareholders. Under section 1366(a)(1) of the Code a
subchapter S shareholder's portion of the corporation's tax liability is deter-
mined by taking into account the shareholder's pro rata share of the corpo-
ration's separately computed items and the corporation's nonseparately
computed income or loss.\(^8\) Separately computed items are items of income,
loss, deduction, or credit flowing to and reported by the shareholder on an
item-by-item basis.\(^9\) Nonseparately computed items constitute a hotchpot of

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\(^5\) See infra notes 83-89 and accompanying text.
\(^6\) 778 F.2d 769 (11th Cir. 1985).
\(^7\) Id. at 775.
\(^8\) I.R.C. § 1366(a) (1986) provides:
   (a) Determination of shareholder's tax liability.
   (1) In general. In determining the tax under this chapter of a shareholder for the
       shareholder's taxable year in which the taxable year of the S corporation ends (or
       for the final taxable year of a shareholder who dies before the end of the corpora-
       tion's taxable year), there shall be taken into account the shareholder's pro rata
       share of the corporation's—
       (A) items of income (including tax-exempt income), loss, deduction, or credit
           the separate treatment of which could affect the liability for tax of any share-
           holder, and
       (B) nonseparately computed income or loss.
       For purposes of the preceding sentence, the items referred to in subparagraph (A)
       shall include amounts described in paragraph (4) or (6) of section 702(a).
   (2) Nonseparately computed income or loss defined. For purposes of this sub-
       chapter, the term "nonseparately computed income or loss" means gross income
       minus the deductions allowed to the corporation under this chapter, determined by
       excluding all items described in paragraph (1)(A).
\(^9\) See id. § 1366(a)(1).
residual items escaping separate treatment. This provision has the effect of taxing S corporation shareholders in a manner similar to the taxation of partners under subchapter K of the Code, since a shareholder determines items that are separately computed by partial reference to partnership tax provisions in the Code. Section 1366(a)(2) provides that the character of all items passed through to shareholders have the same character as if the shareholder realized the item directly from the source from which the corporation realized the item.

Section 1366(d)(1) limits the pass-through of losses and deductions to the shareholder for any taxable year to the sum of the shareholder's adjusted basis in stock and the shareholder's basis in any indebtedness of the corporation to the shareholder. This limitation provision formerly existed in section 1374(c)(2). The Subchapter S Revision Act of 1982, however, shifted the limitation to section 1366(d)(1), effective January 1, 1983. Thus, most of the case law dealing with basis as it relates to shareholder loan guarantees refers to former section 1374.

Prior to the enactment of the Subchapter S Revision Act of 1982, an S corporation shareholder whose pro rata share of losses exceeded the loss limitation lost the deduction forever. This rule resulted in a harsh trap for shareholders whose typically unsuccessful efforts to generate basis by guaranteeing corporate debt resulted in the permanent relinquishment of the unused loss. Had such shareholders known the potential consequences, they could have personally borrowed money and then advanced the funds to the corporation, thereby qualifying for basis generation on the face of the statute. Congress, in an attempt to mitigate traps of this variety, added section 1366(d)(2) in the Subchapter S Revision Act of 1982 to allow shareholders an indefinite carryover to subsequent taxable years of losses and deductions.

10. See id. § 1366(a)(2).
11. Id. §§ 701-761.
12. Id. § 1366(a)(1). Section 702, referenced in id. § 1366(a)(1), provides for the separate and nonseparate computation of partnership items. Accordingly, tax items that the S corporation shareholder separately computes essentially parallel those items computed separately by partners. For a discussion of the items that are computed separately see I. Grant, Subchapter S Taxation § 16.4 (rev. ed. 1986).
14. Id. § 1366(d)(1) provides:
   (d) Special rules for losses and deductions.
   (1) Cannot exceed shareholder's basis in stock and debt. The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of—
      (A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraph (1) of section 1367(a) for the taxable year), and
      (B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).
16. Id. § 6, 96 Stat. at 1697.
in excess of the loss limitation.\textsuperscript{19}

In spite of Congress's effort to make S corporation provisions more like partnership provisions by allowing a carryover of losses and deductions,\textsuperscript{20} important differences remain between the provisions with respect to loss limitations. One example is the treatment of liabilities of the entity. Under sections 752(a) and 722, an increase in a partner's share of partnership liabilities results in an increased basis in the partner's interest in the partnership.\textsuperscript{21} Subchapter S contains no similar provision. This conceptual difference often results in larger deductions of losses to partners than their S corporation shareholder counterparts.\textsuperscript{22}

\textit{A. Basis of Stock}

A shareholder's adjusted tax basis in an S corporation's stock forms part of the limitation on the pass-through of losses and deductions. Subchapter S contains no provisions specifying how a shareholder initially determines stock basis. Presumably, other applicable provisions of the Code determine the initial stock basis. For example, purchased stock has a cost basis under section 1012,\textsuperscript{23} inherited stock has a basis equal to the fair market value of the stock at the date of the decedent's death under section 1014,\textsuperscript{24} stock acquired by gift has the donor's carryover basis under section 1015,\textsuperscript{25} and stock received as compensation has a basis of the fair market value at the time of receipt under section 83.\textsuperscript{26}

However basis is initially determined, section 1367(a)(1) provides that the stock basis increases by the sum of all separately computed items of income (including tax-exempt income), nonseparately computed income, and excess depletion deductions.\textsuperscript{27} The income items increase stock basis only to the extent that they are included in the shareholder's personal gross income.\textsuperscript{28} Section 1367(a)(2) states that several items decrease a shareholder's stock basis.\textsuperscript{29} These items include corporate distributions not included in the income of the shareholder by virtue of section 1368,\textsuperscript{30} and separately and non-

\textsuperscript{19} I.R.C. § 1366(d)(2) (1986).
\textsuperscript{21} I.R.C. § 752(a) (1986) treats the liability as a contribution of money or property by the partner. Id. Section 722 provides that a partner’s basis increases upon a contribution of money or property. Id. § 722.
\textsuperscript{22} I. Grant, supra note 12, § 18.3, at 18-8.
\textsuperscript{23} I.R.C. § 1012 (1986); see Byrne v. Commissioner, 45 T.C. 151, 154 (1965), aff’d, 361 F.2d 939 (7th Cir. 1966).
\textsuperscript{24} I.R.C. § 1014 (1986); see McIntosh v. Commissioner, 26 T.C.M. (CCH) 1164, 1174 (1967).
\textsuperscript{25} I.R.C. § 1015 (1986); see Sauvigne v. Commissioner, 30 T.C.M. (CCH) 123, 124 (1971).
\textsuperscript{26} I.R.C. § 83 (1986); see Sauvigne v. Commissioner, 30 T.C.M. (CCH) 123, 124 (1971).
\textsuperscript{27} I.R.C. § 1367(a)(1) (1986).
\textsuperscript{28} Id. § 1367(b). Although the Code fails to specify when the basis adjustment occurs, the adjustment probably occurs at the end of the corporation’s fiscal year. I. Grant, supra note 12, § 19.3, at 19-14.
\textsuperscript{29} I.R.C. § 1367(a)(2) (1986).
\textsuperscript{30} Id. § 1368(b)(1) provides that distributions are tax-free to the extent of the share-
separately computed losses and deductions, including nondeductible expenses.\textsuperscript{31}

\section*{B. Basis of Indebtedness}

In addition to the adjusted basis of the shareholder’s stock, the basis of indebtedness of the S corporation to the shareholder further restricts the deductibility of loss and deduction pass-throughs.\textsuperscript{32} Indebtedness within the meaning of the statute is conceptually analogous to actual capital investment.\textsuperscript{33} The debt must run directly from the corporation to the shareholder.\textsuperscript{34}

Courts have narrowly construed the indebtedness limitation.\textsuperscript{35} The Tax Court has held that indebtedness of a corporation to a partnership owned identically by the shareholders of the debtor corporation did not increase the shareholders’ debt bases.\textsuperscript{36} Similarly, loans from a subchapter C\textsuperscript{37} corporation to an identically owned S corporation did not generate basis.\textsuperscript{38} The Tax Court has also ruled that loans from an estate to an S corporation did not generate basis to a shareholder who was the sole beneficiary of the estate,\textsuperscript{39} and that notes given by an S corporation to a shareholder for unpaid salary did not result in an increase in the basis of indebtedness.\textsuperscript{40}

As discussed earlier, certain items reduce the basis of the shareholder’s stock.\textsuperscript{41} The reduction, however, cannot cause a negative basis.\textsuperscript{42} Any excess of these reduction items over the stock basis then reduces the basis of indebtedness owing to the shareholder, but again, that basis cannot be reduced below zero.\textsuperscript{43} When the basis of indebtedness is reduced, repayment of the debt by the corporation results in income to the shareholder equal to the difference between the amount paid and the basis.\textsuperscript{44} If the corporation

\textsuperscript{31} I.R.C. § 1367(a)(2) (1982). The Code does not address the question of basis reduction when shareholders have various stockholdings with different bases. Under prior law, shareholders reduced basis on a pro rata basis. I. GRANT, supra note 12, § 19.4, at 19-17. The basis reduction occurred at the close of the corporation’s tax year in which the corporation incurred the losses and deductions. Id. at 19-18.


\textsuperscript{33} Underwood v. Commissioner, 535 F.2d 309, 311 (5th Cir. 1976) (discussion of legislative history to support investment analogy); Neal v. United States, 313 F. Supp. 393, 396 (C.D. Cal. 1970) (funds must be advanced as if shareholder made additional investment).

\textsuperscript{34} See Burnstein v. Commissioner, 47 T.C.M. (CCH) 1100, 1103 (1984); Prashker v. Commissioner, 59 T.C. 172, 176 (1972).

\textsuperscript{35} See I. GRANT, supra note 12, § 19.2, at 19-8.

\textsuperscript{36} Frankel v. Commissioner, 61 T.C. 343, 350 (1973); Rev. Rul. 69-125, 1969-1 C.B. 207.

\textsuperscript{37} I.R.C. §§ 301-386 (1986).

\textsuperscript{38} Lee v. Commissioner, 35 T.C.M. (CCH) 1157, 1159-60 (1976).

\textsuperscript{39} Prashker v. Commissioner, 59 T.C. 172, 176 (1972).

\textsuperscript{40} Borg v. Commissioner, 50 T.C. 257, 262-64 (1968).

\textsuperscript{41} See supra notes 29-31 and accompanying text.

\textsuperscript{42} I.R.C. § 1367(a)(2) (1986).

\textsuperscript{43} Id. § 1367(b)(2)(A). Current law provides that subsequent income to the corporation results in restoration of the basis of indebtedness. Id. § 1367(b)(2)(B).

\textsuperscript{44} Cornelius v. Commissioner, 494 F.2d 465, 469-70 (5th Cir. 1974); Barr v. Commis-
repays the debt in installments, the corporation must proportionately allocate each installment between income and basis restoration.  

II. IMPACT OF SHAREHOLDER LOAN GUARANTEES ON BASIS

As small business enterprises, new or existing S corporations often require substantial debt financing in order to obtain necessary operating capital. Because of the risk element involved in many small corporations, lenders frequently insist that one or more of the shareholders of the S corporation personally guarantee the debt. If the corporation subsequently incurs net operating losses, shareholders, attempting to maximize the deduction on their own tax returns of loss and deduction pass-throughs under section 1366(a), often argue that their personal guarantee of the corporation's loan serves to increase the basis of indebtedness of the corporation owed to the shareholder or the basis of the shareholder's stock in the corporation. The result, the argument goes, is that the increased basis allows a larger pass-through of deductions under section 1366(a).

Supported by a long tradition of case law, courts have generally held that shareholder loan guarantees do not generate basis for the shareholder in the S corporation. Courts have adhered to this rule regardless of whether the...
shareholder pledged property as security on the loan, or whether, under state law, the guarantee resulted in primary or secondary liability to the shareholder. Moreover, this rule has extended to many types of indirect borrowing, including suretyship, comaking, co-indemnity, and joint and several liability.

Shareholders could generate additional basis simply by borrowing money themselves and then contributing the money to the corporation. The loan guarantee problem persists, however, because many shareholders enter into financing arrangements without first obtaining tax counsel. Although shareholders who are denied a basis increase may carry over any unused losses under section 1366(d)(2), this carryover ability remains unacceptable to many shareholders who seek short-term loss pass-throughs.

partnership owned by shareholders in exact proportion to shareholdings loaned money to corporation), aff'd mem., 506 F.2d 1051 (3d Cir. 1974); Estate of Cole v. Commissioner, 32 T.C.M. (CCH) 313, 328 (1973) (shareholder's guarantee did not increase basis); Blum v. Commissioner, 59 T.C. 436, 438 (1972) (shareholder's guarantee did not represent indebtedness of the corporation to him or an equity contribution in substance); Prashker v. Commissioner, 59 T.C. 172, 177 (1972) (shareholder could not increase basis when corporation owed money to estate of which he was sole beneficiary); Raynor v. Commissioner, 50 T.C. 762, 770-71 (1968) (guarantee did not increase basis); Borg v. Commissioner, 50 T.C. 257, 264-65 (1968) (shareholders could not increase basis when they were sureties and had pledged business and personal assets); Priv. Ltr. Rul. 8,426,006 (June 29, 1984) (shareholder's primary liability not debt from corporation until shareholder pays the liability); see Perry v. Commissioner, 392 F.2d 458, 461 (8th Cir. 1968) (since shareholders loaned no money to corporation, no debt existed; therefore, shareholders denied basis increase); Harrington v. United States, 605 F. Supp. 53, 59 (D. Del. 1985) (shareholders could not increase basis by being comakers on note); Burnstein v. Commissioner, 47 T.C.M. (CCH) 1100, 1105-06 (1984) (shareholders denied increase in basis to extent corporation borrowed money from another S corporation owned by identical interests); Tuchman v. Commissioner, 43 T.C.M. (CCH) 192, 195 (1981) (shareholder who made no payments on guaranteed obligation denied basis increase), aff'd mem., 697 F.2d 298 (2d Cir. 1982); Lord v. Commissioner, 29 T.C.M. (CCH) 653, 658 (1970) (shareholders could take loss in year mortgage given by them as security satisfied, not in year in which they guaranteed corporation's debt).


56. Under prior law, a shareholder who could not generate enough basis to deduct his entire operating loss lost the deduction forever. Albert v. Commissioner, 41 T.C.M. (CCH) 591, 597 (1980); Floward v. Commissioner, 48 T.C. 666, 671 (1967), aff'd per curiam, 398 F.2d 340, 341 (4th Cir. 1968); cf. Byrne v. Commissioner, 45 T.C. 151, 158 (1965) (shareholder who had insufficient stock basis lost excess deduction), aff'd, 361 F.2d 939 (7th Cir. 1966).

57. See supra text accompanying notes 17-19.
A. Basis of Indebtedness of the Corporation to the Shareholder

The most common argument advanced in favor of increasing the basis of indebtedness of the corporation to the shareholder is that the shareholder's guarantee represents, in substance if not form, a loan to the shareholder, followed by a loan from the shareholder to the corporation. A transaction viewed in this manner, according to shareholders, thus generates basis in indebtedness of the corporation to the shareholder under section 1366(d)(1)(B).58 Courts, however, have reasoned that guarantees do not represent indebtedness of the corporation to the shareholder within the meaning of the statute. The legislative history requires that a shareholder make an investment in the corporation in order to generate basis.59 Courts have interpreted the word "investment" as requiring an actual economic outlay by the shareholder,60 and stated that Congress intended debt basis to be conceptually analogous to a capital investment.61

Courts have also reasoned that shareholder loan guarantees do not constitute indebtedness within the meaning of section 1366(d)(1)(B) because the corporation owes nothing directly to the shareholder.62 Courts have treated the guarantee as only a contingency that does not become a debt of the corporation until the contingency has happened:63 the corporation must default on the loan. Accordingly, a shareholder who ultimately pays the guaranteed debt receives an increase in basis in the S corporation.64 This basis increase occurs in the year the shareholder makes payment; it does not relate back to the year in which the shareholder guaranteed the corporation's debt.65

The Sixth Circuit had an opportunity to consider the impact of shareholder loan guarantees on basis in Brown v. Commissioner.66 Like so many taxpayers before him, the shareholder in Brown argued that his guarantee constituted, in substance, a loan from the lender to him, followed by an advance of the funds to the corporation. The court, however, refused to accept

58. In virtually all the cases dealing with this argument, former § 1374(c)(2)(B), the predecessor to § 1366(d)(1)(B), applied. See supra text accompanying notes 14-16.
60. See Underwood v. Commissioner, 535 F.2d 309, 311 (5th Cir. 1976); Thompson v. Commissioner, 36 T.C.M. (CCH) 157, 161 (1977); Duke v. Commissioner, 35 T.C.M. (CCH) 229, 231 (1976); Perry v. Commissioner, 47 T.C. 159, 164 (1966), aff'd on other grounds, 392 F.2d 458 (8th Cir. 1968); Priv. Ltr. Rul. 8,426,006 (June 29, 1984).
64. Neal v. United States, 313 F. Supp. 393, 396 (C.D. Cal. 1970). This principle is based on Putnam v. Commissioner, 352 U.S. 82, 85 (1956), in which the United States Supreme Court held that when a guarantor performs, the corporation becomes indebted to the shareholder.
66. 706 F.2d 755 (6th Cir. 1983).
the shareholder's substance over form argument, stating that the shareholder must accept the tax consequences of the transaction into which he entered. The court stated that shareholder loan guarantees simply do not meet the economic outlay requirement of S corporation basis. The court added that shareholders must make payments on guaranteed corporate indebtedness before their basis will increase.

The Internal Revenue Service has ruled that a shareholder who substituted a personal demand note for a guaranteed corporate loan generated additional basis in the S corporation. In Revenue Ruling 75-144, a shareholder, instead of making payment on a guaranteed debt, executed a personal promissory note and substituted it for the corporation's note. The bank accepted the substitution of the note and relieved the corporation of any liability. The taxpayer made no payments until the fourth year following the substitution of notes. These facts raised the question of whether substitution of a shareholder's note for the corporation's guaranteed note created basis-generating indebtedness within the meaning of former section 1374(c)(2).

The Service ruled that such a substitution generates basis if, under state law, the corporation's debt to the lender becomes an obligation to the shareholder-guarantor under the doctrine of subrogation. Under subrogation, if the lender accepts the note in full satisfaction of the corporation's debt, the guarantor becomes a creditor of the corporation, even if the shareholder makes no payments on the principal. The substitution therefore generates basis in an amount equal to the face amount of the note given up.

The Tax Court went a step further than Revenue Ruling 75-144 in Gilday v. Commissioner. In Gilday a shareholder-guarantor substituted a personal note for a guaranteed corporate debt, but subrogation did not occur under state law. The Tax Court nevertheless held that the corporation became indebted to its shareholders regardless of whether subrogation occurred.

67. Id. at 756. In the court's opinion, the substance of the transaction matched its form. For a discussion of the substance over form doctrine see infra notes 179-87 and accompanying text.

68. 706 F.2d at 756. The court stated that without the economic outlay requirement, taxpayers could circumvent the limitations contained in former § 1374(c) in a way never intended by Congress. Id. The court also dismissed the taxpayer's argument that the guarantee constituted a contribution to capital. Id. The Tax Court addressed this issue in Blum v. Commissioner, 59 T.C. 436, 439-40 (1972). For a discussion of Blum see infra notes 84-89 and accompanying text.


70. 1975-1 C.B. 277. This ruling amplified Rev. Rul. 70-50, 1970-1 C.B. 178, which held that a shareholder who performs on a guarantee may increase basis in the corporation.

71. 1975-1 C.B. at 278 (relying on Putnam v. Commissioner, 352 U.S. 82 (1956); see supra note 64).

72. Id.

73. Id.; see also J. EUSTICE & J. KUNTZ, supra note 1, ¶ 10.03[2][k], at 10-37 (discussing alternative ways of viewing the substitution).

74. 43 T.C.M. (CCH) 1295 (1982).

75. Id. at 1297. The court apparently based its holding upon a finding of fact that the corporation itself was indebted to the shareholders. For a discussion of Rev. Rul. 75-144 and
The court therefore allowed the shareholders to increase their bases in the corporation.\textsuperscript{76}

The Fifth Circuit reached a contrary result in Underwood v. Commissioner.\textsuperscript{77} In Underwood a taxpayer owned all the stock in two corporations, one an S corporation and the other a C corporation. The S corporation had borrowed money from the other corporation. Needing to generate some basis for purposes of the loss limitation, the taxpayer authorized several transactions. First, the C corporation that had loaned the money surrendered the notes of the S corporation. Then, the S corporation issued a demand note to the taxpayer. The taxpayer then gave a personal note to the C corporation. All the notes contained identical principal amounts. The court treated the transaction as a guarantee by the taxpayer of the S corporation’s debt to the C corporation.\textsuperscript{78} Citing authority holding that mere guarantees do not generate basis,\textsuperscript{79} the court held that the taxpayer could not increase basis since he had made no actual payments on the debt.\textsuperscript{80}

The court distinguished the Underwood facts from the facts in Revenue Ruling 75-144 in two ways. The obligee in Revenue Ruling 75-144 was a bank, whereas Mr. Underwood’s creditor was his own corporation.\textsuperscript{81} Unlike the situation in Revenue Ruling 75-144, no proof existed in Underwood that the original creditor would demand from the taxpayer payment of the substituted note.\textsuperscript{82}

\textbf{B. Basis of Shareholder’s Stock in the Corporation}

Courts have most frequently disallowed an increase in basis when a shareholder guaranteed a corporate loan on the grounds that the guarantee did not increase the basis of indebtedness of the S corporation to the shareholder under section 1366(d)(1)(B) or former section 1374(c)(2). In some cases, however, taxpayers have argued that the loan guarantee constituted an increase in the basis of the shareholder’s stock under section 1366(d)(1)(A).\textsuperscript{83} The Tax Court considered this question in Blum v. Commissioner.\textsuperscript{84} In Blum the shareholder personally guaranteed a loan to his solely owned S corporation and secured the loan with shares of stock that he held in other corporations. After dismissing the shareholder’s argument that the guarantee constituted an addition to debt basis,\textsuperscript{85} the court turned to the question

\textsuperscript{76} Gilday, see Mullaney & Blau, \textit{An Analytic Comparison of Partnerships and S Corps as Vehicles For Leveraged Investments}, 59 J. TAX’N 142, 143-45 (1983).

\textsuperscript{77} 43 T.C.M. (CCH) at 1297.

\textsuperscript{78} 535 F.2d 309 (5th Cir. 1976).

\textsuperscript{79} Id. at 312.

\textsuperscript{80} See cases cited supra note 47.

\textsuperscript{81} 535 F.2d at 312. For a discussion of Underwood see Malloy & Willis, \textit{Careful Debt Planning Can Save Subchapter S Net Operating Loss Passthrough}, 53 TAXES 373, 375 (1975).

\textsuperscript{82} Id. at 312 n.2.


\textsuperscript{84} 59 T.C. 436 (1972).

\textsuperscript{85} Id. at 438 (citing Raynor v. Commissioner, 50 T.C. 762, 770-71 (1968)).
of whether the guarantee could be recast as an indirect contribution to capital under the substance over form doctrine.\textsuperscript{86} The court noted that the Commissioner had applied the substance over form argument in the past in recharacterizing shareholder guaranteed loans as equity investments for the purpose of denying corporations a deduction for interest paid on the loan.\textsuperscript{87} The court stated that although the question of whether guaranteed loans constitute, in substance, contributions to capital usually arises in the context of disallowed interest deductions, the answer to the question in the context of S corporation basis should turn on the same traditional debt-equity principles used in the interest deduction context.\textsuperscript{88} Under these principles, the court concluded that the taxpayer simply had not met his burden of proving that the loan guarantee should be recharacterized as an equity investment.\textsuperscript{89}

III. \textit{Selfe v. United States}

Against a long tradition of case law holding that S corporation shareholder loan guarantees do not generate basis in the corporation, a case finally appeared that may have signaled the erosion of the traditional rule. In \textit{Selfe v. United States}\textsuperscript{90} the Eleventh Circuit held that a shareholder who guarantees a corporate loan may increase basis in either the stock or the indebtedness of the corporation upon a factual determination by the court that the guarantee, in substance, constitutes a loan from the lender to the shareholder that is followed by an advance of the funds from the shareholder to the corporation.\textsuperscript{91}

In 1977 Jane B. Selfe began a retail clothing business. She applied to a local bank for financing and, in exchange for financing, she pledged shares of stock in another corporation. She then incorporated her business and elected to be taxed under subchapter S of the Code. At the request of the bank, Mrs. Selfe converted almost all of the debt from herself to the corporation and agreed personally to guarantee the loans.\textsuperscript{92} The corporation, seeking a loan renewal from the bank, later granted the bank a security interest in its inventory, contract rights, and receivables. Upon commencing opera-

\begin{itemize}
\item \textsuperscript{86} \textit{Id}. at 439.
\item \textsuperscript{87} \textit{Id}.; see \textit{infra} notes 136-78 and accompanying text.
\item \textsuperscript{88} \textit{59 T.C.} at 439 (citing \textit{Santa Anita Consol., Inc. v. Commissioner}, \textit{50 T.C.} 536, 550 (1968)).
\item \textsuperscript{89} \textit{Id}. at 440. In denying the stock basis increase, the court provided valuable information on what factors might persuade a court to recast a guarantee as a capital contribution. Although no single factor is dispositive, relevant factors include: whether the corporation is thinly capitalized; whether the corporation is insolvent at the time of the loan; whether the lender expects payment from the corporation, rather than the shareholder; whether the loan instrument evidences an unconditional obligation to pay a fixed sum; whether the debt bears a fixed rate of interest payable unconditionally; whether the debt is subordinated; and whether the debt carries voting rights. \textit{Id}. at 440-41. For discussion of these factors outside of the S corporation context see \textit{supra} text accompanying notes 136-78.
\item \textsuperscript{90} \textit{778 F.2d} 769 (11th Cir. 1985).
\item \textsuperscript{91} \textit{Id}. at 772-73.
\item \textsuperscript{92} \textit{At trial, the bank's loan officer testified that the purpose of the conversion was to obtain primary liability in the corporation. The conversion, however, altered neither the stock security nor the bank's right to collect from Mrs. Selfe as guarantor.} \textit{Id}. at 771.
\end{itemize}
tions, the corporation experienced losses from 1977 to 1980. The corporation, however, never defaulted on its loan.93

Mrs. Selfe and her husband increased their basis in the corporation by the amount of the guaranteed debt and deducted the full amount of their net operating losses under former section 1374(a).94 The government disallowed most of the deduction,95 asserting that the guarantee did not increase the Selfe's basis in the corporation for purposes of the former section 1374(c) net operating loss limitation. The Selfes paid the deficiency and sued the United States for a refund in a federal district court, which granted summary judgment to the United States.96 The Selfes appealed to the Eleventh Circuit.

The Selfes argued on appeal that the guaranteed loan constituted, in substance, a loan to Mrs. Selfe from the bank that was followed by a capital contribution to the corporation. The loan thereby increased the basis of Mrs. Selfe's stock. The Selfes relied heavily on Plantation Patterns, Inc. v. Commissioner,97 a Fifth Circuit decision holding in a non-S corporation context that a loan is considered as made to a shareholder who guarantees the loan when the facts demonstrate that the lender looked principally to the shareholder for repayment.98 The Eleventh Circuit agreed with the Selfes and disagreed with Brown v. Commissioner,99 which held that an S corporation shareholder must actually make payment on debt guaranteed by the shareholder before a basis increase occurs.100

The court next turned its attention to the Selfe’s substance over form argument. The court agreed with the government’s assertion that taxpayers must accept the tax consequences of the transaction into which they have

93. The bank, therefore, never proceeded against the pledged stock or Mrs. Selfe.
94. I.R.C. § 1366(a) (1986) currently allows the pass-through of losses and deductions. See supra text accompanying notes 14-16.
95. The court only considered the Selfe's 1980 tax liability.
96. The district court, in an unreported decision, relied primarily on Brown v. Commissioner, 706 F.2d 755 (6th Cir. 1983). 778 F.2d at 772; see supra notes 66-69 and accompanying text.
97. 462 F.2d 712 (5th Cir. 1972), cert. denied, 409 U.S. 1076 (1972).
98. Id. at 724. Plantation Patterns did not decide whether an S corporation shareholder could generate basis in the corporation by guaranteeing corporate debt. Rather, that case determined that a C corporation shareholder's loan guarantee constituted, in substance, an indirect capital contribution to the corporation, resulting in a denial of the interest deduction to the corporation and dividend income to the shareholder-guarantor. For a discussion of Plantation Patterns see infra notes 171-78 and accompanying text. Plantation Patterns was precedential because the Eleventh Circuit adopted as precedent decisions of the Fifth Circuit rendered prior to October 1, 1981. Bonner v. City of Prichard, 661 F.2d 1206, 1209 (11th Cir. 1981). In Lane v. United States, 742 F.2d 1311, 1320 (11th Cir. 1984), the Eleventh Circuit stated that it would seriously consider the holding in Plantation Patterns when determining whether a shareholder who advances funds to a corporation has made an indirect capital contribution.

Mrs. Selfe also argued that the loan should be characterized as equity under former Treas. Reg. § 1.385-9 (1980). The court, however, noted that the IRS withdrew that regulation in 1983. 778 F.2d at 772. For a discussion of Treas. Reg. § 1.385-9 (1980) see infra notes 132-34 and accompanying text.
99. 706 F.2d 755 (6th Cir. 1983).
100. Id. at 757. The Brown court noted that a guarantor who has pledged stock for a loan has made an economic outlay, since the stock is no longer available for other investments. Id. at 756. For a discussion of Brown see supra notes 66-69 and accompanying text.
entered and, thus, may not later argue that the substance of their transaction should warrant different, presumably more favorable, tax treatment.\(^\text{101}\) The court, however, also noted that tax consequences are not always determined solely by reference to the form of the transaction.\(^\text{102}\) In other words, the tax treatment of transactions sometimes follows substance, rather than form. The court stated that the substance over form doctrine particularly applies to the question of whether corporate capital is characterized as debt or equity for tax purposes.\(^\text{103}\) The court noted that the Fifth Circuit, at the Commissioner’s request in *Plantation Patterns*, recharacterized interest payments on corporate debentures as constructive shareholder dividends.\(^\text{104}\) The court determined that taxpayers, as well as the government, may argue for recharacterization of debt as equity.\(^\text{105}\) Section 385 provided the authority for such recharacterization; it authorized the Secretary of the Treasury to prescribe regulations\(^\text{106}\) and provided factors to be considered in making the determination.\(^\text{107}\) Additionally, the Eleventh Circuit in *Lane v. United States*\(^\text{108}\) had developed its own set of thirteen factors to guide courts in determining whether corporate instruments constitute debt or equity.\(^\text{109}\) The *Selfe* court therefore concluded that courts may tax transactions according to their substance when faced with a question concerning the nature of a taxpayer’s interest in a corporation, guided by the factors set forth in section 385 and *Lane*.\(^\text{110}\)

The *Selfe* court then returned to a consideration of Mrs. Selfe’s loan guarantee. In the court’s opinion, taxpayer attempts to generate basis in S corporations by guaranteeing loans failed in the past usually because the taxpayers could not demonstrate that the substance of the loan guarantee differed from its form.\(^\text{111}\) The court refused to allow the failure of past taxpayers, however, to translate into a categorical rejection of the recharacterization argument.\(^\text{112}\) The court therefore held that a shareholder loan guarantee, in substance, may be treated as an equity investment in the corporation or as corporate indebtedness to the shareholder for the purpose of increasing the shareholder’s basis in the S corporation.\(^\text{113}\) A taxpayer can prevail by demonstrating that the lender looked primarily to the shareholder for repayment and that the guarantee constitutes a capital contribution under traditional

\(^{101}\) 778 F.2d at 773 (citing Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974)).

\(^{102}\) *Id.* (citing Higgins v. Smith, 308 U.S. 473, 477 (1940)).

\(^{103}\) *Id.*

\(^{104}\) *Id.* For a discussion of *Plantation Patterns* see infra notes 171-78 and accompanying text.

\(^{105}\) 778 F.2d at 774.

\(^{106}\) I.R.C. § 385(a) (1986).

\(^{107}\) *Id.* § 385(b).

\(^{108}\) 742 F.2d 1311 (11th Cir. 1984).

\(^{109}\) The Eleventh Circuit developed the thirteen factors by following the Fifth Circuit’s decision in Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972).

\(^{110}\) See 778 F.2d at 773-74.

\(^{111}\) *Id.* at 774; see supra text accompanying notes 83-91.

\(^{112}\) 778 F.2d at 774.

\(^{113}\) *Id.*
debt-equity principles. The court reversed the district court's order granting summary judgment for the United States and remanded the case to the district court.

IV. RECHARACTERIZATION OF THE LOAN GUARANTEE AS AN EQUITY INVESTMENT

The court's holding in Selfe rested on precedential cases outside the scope of subchapter S in which courts recast loan guarantees as indirect capital contributions. Thus, a proper understanding of Selfe requires an analysis of the following: (1) debt-equity principles; (2) circumstances under which courts have recharacterized guarantees as indirect capital contributions in non-subchapter S settings; and (3) the substance versus form doctrine.

A. DEBT-EQUITY PRINCIPLES

Much litigation has surrounded attempts to determine whether corporate securities constitute, in substance, debt or equity for purposes of federal taxation. A typical scenario involves shareholders' advancing funds to a corporation under the rubric of indebtedness, but utilizing debt instruments that contain equity features. For example, a corporation might issue to shareholders debentures that are convertible into preferred stock at a given time. If the security is classified as debt, the corporation may deduct interest payments, and the shareholder includes in income that portion of the payment representing interest. If a court classifies the security as equity, however, the corporation loses the interest deduction and the shareholder must include the full payment as dividend income. Thus, taxpayers usually argue for classification of the security as debt. The typical debt-equity dispute does not involve the question of whether a shareholder loan guarantee constitutes an equity investment for purposes of S corporation basis, as in Selfe. Nevertheless, traditional debt-equity principles govern the shareholder loan guarantee question.

114. Id. at 774-75.
115. Id. at 775.
120. Id. § 61(a)(4).
121. The Internal Revenue Code currently allows corporations no deduction for dividends paid.
123. B. Bittker & J. Eustice, supra note 118, ¶ 4.02, at 4-5.
124. Casco Bank & Trust Co. v. United States, 544 F.2d 528, 534-35 (1st Cir. 1976); Plantation Patterns, 462 F.2d at 719; Smyers v. Commissioner, 57 T.C. 189, 198 (1971); Santa Anita Consol., Inc. v. Commissioner, 50 T.C. 436, 550 (1968).
Courts have traditionally determined whether a given corporate security constituted debt or equity on an ad hoc basis. Courts have generally used enumerated factors in making the determination. No single factor controls the determination. Since the outcome rests on a case-by-case factual determination, predictions based on existing case law are dangerous, and trial court determinations are not easily overturned.

In response to the confusion generated by debt-equity litigation, Congress added section 385 to the Code with the enactment of the Tax Reform Act of 1969. Section 385(a) authorizes the Secretary of the Treasury to promulgate regulations appropriate to determine whether an interest in a corporation constitutes stock or indebtedness for tax purposes. Section 385(b) lists five nonexclusive factors to guide the Secretary in promulgating regulations. In 1980 the Secretary promulgated final regulations for section 385. Regulation 1.385-9 specifically addressed the question of shareholder loan guarantees, stating that if the loan is treated as made to the shareholder under relevant legal principles, then the shareholder is treated as making a contribution to the capital of the corporation. This regulation would greatly benefit S corporation shareholders who guarantee corporate

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125. E.g., John Kelley Co. v. Commissioner, 326 U.S. 521, 526 (1946) (securities cast as debt because of promise to pay a certain annual amount, priority of debentures over common stock, assignability of debentures, and definite maturity date); Lundgren v. Commissioner, 376 F.2d 623, 626 (9th Cir. 1967) (majority shareholder's advances to corporation bona fide debt based upon parties' intent, conventional nature of promissory note, nonsubordination of debt, and no alteration in shareholder's proportional ownership); Adams v. Commissioner, 58 T.C. 41, 56 (1972) (short-term debt treated as bona fide indebtedness because of parties' intent, unqualified promise to pay on a definite date, fixed interest rate, and lack of substantial risk).

126. For example, the Ninth Circuit uses an 11-factor analysis, see O.H. Kruse Grain & Milling v. Commissioner, 279 F.2d 123, 125-26 (9th Cir. 1960), while the Eleventh Circuit utilizes a 13-factor analysis, see Lane v. United States, 742 F.2d 1311, 1314-15 (11th Cir. 1984).


128. B. BITTKER & J. EUSTICE, supra note 118, 4.02, at 4-6 to -7.


131. Id. § 385(b) states:

(b) Factors. The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular fact situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors:

(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,

(2) whether there is subordination to or preference over any indebtedness of the corporation,

(3) the ratio of debt to equity of the corporation,

(4) whether there is convertibility into the stock of the corporation, and

(5) the relationship between holdings of stock in the corporation and holdings of the interest in question.


loans and then seek basis generation. In 1983, however, the Secretary withdrew the section 385 regulations. Presumably, courts must return to the inexact case-by-case factual determinations that existed before the section 385 regulations.

B. Non-Subchapter S Cases

In Selfe the Eleventh Circuit based its holding on Plantation Patterns, which recharacterized a shareholder loan guarantee as an indirect contribution to capital. Plantation Patterns, however, did not concern an S corporation shareholder's attempt to generate basis by guaranteeing a corporate loan. Rather, the case involved the question of whether a C corporation could deduct interest payments made on the corporate debt and whether the shareholders had resulting dividend income. A proper analysis of Selfe, therefore, requires an understanding of cases outside the scope of subchapter S that have considered whether guarantees, in substance, constituted indirect capital contributions.

Courts have stated that this question turns on traditional debt-equity principles. The outcome of a particular case depends heavily on the facts of the case. The time for judging the efficacy of the guarantee is at its inception.

Courts have dealt with the question of whether a guaranteed corporate loan should be recast as a loan to the shareholder, followed by a capital contribution to the corporation, in cases considering a variety of tax consequences. These consequences have included whether the corporation could deduct interest payments and, therefore, whether the shareholder had dividend income. Other cases have involved: whether payments on a guaran-

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135. B. Bittker & J. Eustice, supra note 118, ¶ 4.05 n.45, at S4-7 (Supp. 1984).
136. Plantation Patterns, 462 F.2d at 722-23.
137. See generally Holzman, The Current Trend in Guaranty Cases: An Impetus to Thin-Incorporation?, 11 TAX. L. REV. 29, 44-50 (1955) (relating guarantee transaction area to area of thin incorporations); New Thin Incorporation Threat: Repayment of Guaranteed Bank Loans Treated as Dividends, 23 J. TAX'N 197, 197-99 (1965) (exploring the limits of loan guarantee recharacterization in light of Murphy Logging Co. v. United States, 378 F.2d 222 (9th Cir. 1967)).
138. E.g., Casco Bank & Trust Co. v. United States, 544 F.2d 528, 534-35 (1st Cir. 1976) (advance by stockholder to corporation during corporation's financial difficulty deemed equity); Plantation Patterns, 462 F.2d at 718 (stockholder guarantee deemed capital contribution because funds used to purchase corporate assets, stockholder exercised complete corporate control, and corporation was thinly capitalized); Santa Anita Consol., Inc. v. Commissioner, 50 T.C. 536, 550 (1968) (Commissioner's request to recast guaranteed corporate debt as equity refused; debt instruments evidenced unconditional payment obligation and fixed interest rate; debt was unsubordinated and carried no voting rights).
141. Plantation Patterns, 462 F.2d at 717-18 (guarantee held a capital contribution; therefore, corporation could not deduct interest and shareholder had dividend income); Murphy Logging Co. v. United States, 378 F.2d 222, 224 (9th Cir. 1967) (guarantee held genuine debt); Ackerson v. United States, 277 F. Supp. 475, 478 (W.D. Ky. 1967) (guarantee treated as debt);
teed debt resulted in an ordinary or a capital loss;\textsuperscript{142} whether cancellation of the alleged indebtedness by the shareholder gave rise to taxable income to the corporation;\textsuperscript{143} whether the guarantee destroyed the status of the corporation's stock as small business stock under section 1244;\textsuperscript{144} and whether payments from an acquiring corporation to an acquired corporation to pay off the guaranteed debt in a section 368(c) corporate reorganization resulted in taxable gain to the shareholder.\textsuperscript{145}

Courts have cited various factors in making the classification decision. Some courts have classified the guaranteed debt as genuine indebtedness when the debt instrument contained a fixed maturity date\textsuperscript{146} and fixed rate of interest,\textsuperscript{147} when the corporation made actual payments on the debt,\textsuperscript{148} and when valid business reasons existed for making the guarantee.\textsuperscript{149} Courts have also reasoned that adequate collateral securing the debt corroborated a finding that the guarantee constituted debt.\textsuperscript{150} The Tax Court has added that intent to create a valid indebtedness, use of the entire loan proceeds by the corporation, a custom of shareholder guarantees, and a lack of participation by the lender in the affairs of the corporation support treatment of the guarantee as debt.\textsuperscript{151}

In classifying loan guarantees as indirect capital contributions rather than debt, courts have looked to such factors as exercise of managerial control by the guarantor,\textsuperscript{152} common identity of shareholder and guarantor,\textsuperscript{153} use of a substantial portion of the borrowed funds to purchase capital assets,\textsuperscript{154} and an absence of written evidences of indebtedness.\textsuperscript{155} Thin capitalization of the corporation has also provided strong impetus for equity treatment.\textsuperscript{156} In

\begin{footnotes}
\item[142] Casco Bank & Trust Co. v. United States, 544 F.2d 528, 535 (1st Cir. 1976) (capital loss); Hunter v. Commissioner, 44 T.C.M. (CCH) 385 (1982) (capital loss); Santa Anita Consol., Inc. v. Commissioner, 50 T.C. at 562 (capital loss). If the court recasts the guarantee as a capital contribution, the shareholder must deduct a capital loss under § 165(g). If the guarantee is treated as debt, the shareholder may take an ordinary loss deduction under § 165(a) or § 166(a)(1).
\item[143] J.A. Maurer, Inc. v. Commissioner, 30 T.C. 1273, 1291 (1958) (guarantee held to be equity; no taxable income to petitioner corporation).
\item[144] Smyers v. Commissioner, 57 T.C. 189, 199 (1971) (court's treatment of guarantee as debt allowed § 1244 loss).
\item[145] Rev. Rul. 79-4, 1979-1 C.B. 150 (treatment of guarantee as equity resulted in gain to acquired corporation's shareholder).
\item[146] \textit{E.g.}, Ackerson v. United States, 277 F. Supp. 475, 477 (W.D. Ky. 1967); Smyers, 57 T.C. at 198; Santa Anita Consol., Inc. v. Commissioner, 50 T.C. 536, 550 (1968).
\item[147] \textit{E.g.}, Casco Bank & Trust Co. v. United States, 544 F.2d 528, 532 (1st Cir. 1976); Smyers, 57 T.C. at 198; Santa Anita Consol., Inc. v. Commissioner, 50 T.C. 536, 550 (1968).
\item[148] \textit{See} Santa Anita Consol., Inc. v. Commissioner, 50 T.C. 536, 553 (1968).
\item[152] Plantation Patterns, 462 F.2d at 722; see infra notes 171-78 and accompanying text.
\item[153] \textit{Plantation Patterns,} 462 F.2d at 722.
\item[154] \textit{Id.;} Hunter v. Commissioner, 44 T.C.M. (CCH) 385, 390 (1982).
\item[155] Casco Bank & Trust Co. v. United States, 544 F.2d 528, 532 (1st Cir. 1976).
\item[156] \textit{Plantation Patterns,} 462 F.2d at 722; Hunter v. Commissioner, 44 T.C.M. (CCH) 385,
assessing capitalization, courts often look to the corporation’s debt-equity ratio. The Fifth Circuit recast a guarantee as equity when the corporation had a 125:1 debt-equity ratio. The Ninth Circuit, however, refused to give equity treatment to a guaranteed note when the corporation’s debt-equity ratio exceeded this figure. The Ninth Circuit’s reasoning was that intangible assets, such as the business or financial skills of the shareholder-guarantor, must affect the debt-equity analysis. The Fifth Circuit, however, has declined to consider such intangible assets when assessing the ratio of debt to equity.

Other factors may play a role in the analysis. For example, subordination of the debt to other corporate debts may result in equity classification. Courts have also considered whether the debt carried voting rights, whether the bank looked primarily to the corporation or to the shareholder for repayment, and whether the lender would have made the loan absent a shareholder guarantee.

The Ninth Circuit declined to recast a shareholder loan guarantee as an equity investment in *Murphy Logging Co. v. United States*. The Murphy brothers owned a partnership and a corporation. The partnership owned logging equipment and leased the equipment to the corporation. The corporation contracted to cut timber for the Crown-Zellerbach Corporation. Upon renewal of the contract with Crown-Zellerbach, the Murphys formed a new corporation. The Murphys nominally capitalized the new corporation and decided that the corporation would purchase the logging equipment from the partnership. In order to make this purchase, the corporation borrowed the necessary funds from a bank, and the Murphys individually guaranteed the note. The government argued that the transaction should be treated as a loan from the bank to the Murphys, followed by an investment of the funds by the Murphys in the corporation. This rubric would have resulted in dividend income to the Murphys equal to the purchase price of the equipment.

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390 (1982); see Casco Bank & Trust Co. v. United States, 544 F.2d 528, 532 (1st Cir. 1976); Santa Anita Consol., Inc. v. Commissioner, 50 T.C. 536, 550 (1968).
158. Murphy Logging Co. v. United States, 378 F.2d 222, 224 (9th Cir. 1967); see also Ackerson v. United States, 277 F. Supp. 475, 477-78 (W.D. Ky. 1967) (court considered success and efficient operation of management).
159. *Plantation Patterns*, 462 F.2d at 723.
163. *Id.* at 199; Santa Anita Consol., Inc. v. Commissioner, 50 T.C. 536, 552-53 (1968).
164. 378 F.2d 222 (9th Cir. 1967).
165. Each brother contributed $500 for a total of $1500.
166. The court noted that the Murphys undoubtedly intended through the purchase to step up the basis of the machinery and begin depreciation deductions again. 378 F.2d at 223. This intention, however, did not trouble the court. *Id.*
167. The government also argued for recharacterization of the purchase as a tax-free exchange, which would have resulted in disallowance of stepped-up basis for depreciation purposes. *Id.* at 224.
The court refused to recast the loan guarantee as an equity investment, stating that looking solely at the nominal stated capital of the corporation would oversimplify the analysis. The court stated that the Murphys' contribution of the anticipation of future business from Zellerbach as well as their own reputation for good business practices prevented the corporation from being considered thinly capitalized. The court therefore treated the guarantee as bona fide indebtedness of the corporation, rather than an indirect contribution to capital.

Of course, the Plantation Patterns case involved shareholder loan guarantees. In Plantation Patterns Thomas E. and William Jernigan were the principal owners of the petitioner's predecessor, Old Plantation, which operated a wrought iron furniture business and an office chair business. Desiring to sell the wrought iron furniture business, the Jernigans located a buyer in Mr. Jemison, an experienced investment banker who owned Jemison Investment Company. Mr. Jemison formed Plantation Patterns, Inc. Plantation Patterns, Inc. then contracted to purchase all of Old Plantation's stock from the Jernigans, who would then repurchase the office chair business.

The stock purchase price, $893,314.17, which equaled the net worth of Old Plantation plus $644,909.53, consisted of the following: (1) $100,000 cash; (2) an amount equal to the office chair business, $183,435.84, payable in three equal interest-free installments; and (3) the balance, $609,878.33, payable in equal installments. Mr. Jemison and Jemison Investment Company guaranteed the note representing payment for the balance. Part of this amount, $100,000, was unsubordinated, but the remainder was partially subordinated.

The Fifth Circuit affirmed as not clearly erroneous the Tax Court's finding that the note represented an indirect equity investment in the corporation by Mr. Jemison. The court relied principally on the fact that the petitioner had used the majority of the debt to purchase capital assets, as opposed to using the funds to finance the venture. The court also based its holding on the corporation's thin capitalization, the fact that the sellers agreed to partial subordination of the note only because of Mr. Jemison's guarantee, the exercise of total managerial control by Mr. Jemison, and the identity of interest between the shareholder and the guarantor. In short, the guarantee allowed Mr. Jemison to create borrowing power for the corporation that it would ordinarily lack absent more adequate capitalization. The court

168. Id.
169. Id.
170. Id.
171. Id.
172. Id. at 722-23.
173. Id. at 722.
174. Id. at 724.
175. Id. at 724.
176. Id. at 722-23.
regarded as insignificant the fact that Plantation Patterns, Inc. enjoyed smooth progress and paid its debts; the time for judging the transaction was at its inception.\textsuperscript{177} The court also refused to consider Mr. Jemison's financial skills as an intangible asset in assessing the corporation's debt-equity ratio.\textsuperscript{178}

\textbf{C. Substance Versus Form}

The question of whether a loan guarantee should be recast as an indirect capital contribution also raises the highly fact-sensitive issue of substance versus form.\textsuperscript{179} The relevant question is whether a court should peer beyond the form of a transaction and tax the parties according to the underlying substance of the transaction, or whether a court should tax parties according to the form of the transaction that the parties freely chose. The United States Supreme Court has supported both methods of treatment.

The Court rejected the taxpayer's substance over form argument in \textit{Commissioner v. National Alfalfa Dehydrating & Milling Co.}.\textsuperscript{180} Pursuant to a plan of reorganization, the corporation issued fifty-dollar face value, five-percent debentures in exchange for its own fifty-dollar par value, five-percent preferred shares. At the time, the shares were quoted at thirty-three dollars per share on the over-the-counter market. The corporation claimed amortization deductions equal to the difference between the face value of the debentures and the quoted price of the preferred shares under section 163(a) of the Code. This section allows as interest deductions original-issue discount when an issuer sells debentures on the market for a cash price less than the face amount of the debentures.\textsuperscript{181} Although the corporation had issued the debentures in exchange for its own stock, the corporation urged the Court to treat the transaction, in substance, as an issuance of the debentures for cash, followed by a purchase of the preferred shares with the hypothetical cash. The Court rejected this argument, stating that taxpayers must face the tax consequences of events that actually occurred, not events that might have occurred.\textsuperscript{182} The Court's rationale essentially centered on the corporation's

\textsuperscript{177} \textit{Id.} at 723. At its inception, the corporation's business prospects looked questionable. \textit{Id.}

\textsuperscript{178} \textit{Id.} The court, however, stated that an intangible asset might affect the debt-equity ratio if the asset has a direct and primary relationship to the corporation's success. \textit{Id.}

\textsuperscript{179} See generally Donaldson, \textit{When Substance-Over-Form Argument Is Available to the Taxpayer}, 9 TAX COUNS. Q. 311 (1965) (explaining situations in which taxpayers can prevail using the substance over form doctrine); Comment, \textit{Substance Versus Form in the Interpretation of the Internal Revenue Code}, 1967 U. ILL. L. REV. 816 (explaining most significant substance over form cases).

\textsuperscript{180} 417 U.S. 134 (1974).

\textsuperscript{181} Section 163(a) provides for a deduction for the interest paid or accrued within the taxable year. I.R.C. § 163(a) (1986). The Court had previously established that the interest deduction includes debt discount. Helvering v. Union Pac. R.R., 293 U.S. 282, 287 (1934).

\textsuperscript{182} 417 U.S. at 148; see also Strick Corp. v. United States, 714 F.2d 1194, 1204-07 (3d Cir. 1983) (sale of equipment to related corporation held a taxable event); St. Louis Bank for Co-ops. v. United States, 624 F.2d 1041, 1052 (Ct. Cl. 1980) (interest received by nonexempt cooperative corporation on demand deposits held deductible as patronage source income because income derived from management of surplus funds directly related to services to corporation's members).
failure to prove that it could have purchased its outstanding preferred stock on the open market; the Court refused to speculate for what price the debentures and the stock would have sold.

The Court allowed the substance over form doctrine to prevail in the landmark case of Gregory v. Helvering. The petitioner was the sole owner of United Mortgage Corporation, which held 1000 shares of stock in another corporation. Desiring to bail out the stock with minimum tax consequences, the petitioner formed another corporation, Averill Corporation. Three days after the formation of Averill, United Mortgage transferred to Averill the 1000 shares of stock and issued to the petitioner all the shares in Averill. Averill then dissolved and distributed the 1000 shares to the petitioner, who sold the stock at favorable capital gain rates. The petitioner argued that the transfer of the stock from United Mortgage to Averill constituted a tax-free reorganization. The Court collapsed all the transactions and upheld the Commissioner's position that the transactions constituted, in substance, a dividend of the 1000 shares of stock to petitioner. The Court stated that the taxpayer had contrived a mere device to reduce tax liability and escape the reality of the transactions.

V. IMPLICATIONS, ANALYSIS, AND PROPOSAL

A. Implications of Selfe

The Eleventh Circuit's decision in Selfe has several significant implications. Selfe affirmatively stated that an S corporation shareholder may, under certain circumstances, increase basis by personally guaranteeing corporate debt. Many of the cases preceding Selfe paid lip service to recasting the guarantee as an indirect capital contribution, but none of those cases actually allowed a basis increase. Moreover, Selfe provided guidelines for determining whether the loan guarantee actually constitutes a capital contribution. Selfe also held that the district court could, on remand, recast the guarantee as either an equity investment in, or a shareholder loan to, the corporation. This view expanded the precedent on which the Eleventh Circuit relied, since the precedent treated guarantees as equity investments only. Selfe's creation of a factual test will no doubt send tax practitioners...
scrambling to devise creative arguments for defeating the Commissioner at the trial level.

Aside from the Eleventh Circuit, the Fifth Circuit may host some interesting litigation as well. The Eleventh Circuit relied primarily on the Fifth Circuit’s decision in *Plantation Patterns* in holding that a guarantee may be recast as a capital contribution. The Fifth Circuit has never considered whether a loan guarantee increases basis in an S corporation. Since the Eleventh Circuit is bound by Fifth Circuit decisions rendered prior to October 1, 1981, tax attorneys arguing in the Fifth Circuit will no doubt begin arguing that the Eleventh Circuit logically extended Fifth Circuit precedent in a manner that the Fifth Circuit should readily endorse.

B. Analysis and Proposal

Congress should enact legislation allowing shareholders of S corporations to increase their basis in the corporation under certain circumstances. The substance over form doctrine should apply to recast S corporation loan guarantees as equity investments, just as the doctrine applies to recast guarantees as equity in non-subchapter S cases. No valid reasons exist for applying the substance over form doctrine in one instance and not in the other. Since the two scenarios involve the same factual setting, justice requires allowing shareholders to argue the doctrine, just as the Commissioner has successfully argued the doctrine in the past. *Selfe* logically extends existing case law in this area.

The recommended legislation should incorporate the *Selfe* tests for determining when a guarantee, in substance, results in an increase in stock basis. *Selfe* states that basis increase results when shareholders demonstrate that the lender looked primarily to the shareholders for repayment, and when traditional debt-equity principles favor recharacterization of the guarantee as a capital contribution. By applying debt-equity principles, coupled with an examination of the lender’s intent, no doubts will exist concerning the true nature of the guarantee. Moreover, these tests reduce the possibility of tax abuse, since a court may readily examine the lender’s intention by way of direct testimony. The tests also allow the courts the flexibility of applying their own established debt-equity principles. Should the Secretary of the

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193. 778 F.2d at 774.
194. After being split off from the Fifth Circuit, the Eleventh Circuit adopted as binding precedent Fifth Circuit decisions rendered prior to October 1, 1981. Bonner v. City of Prichard, 661 F.2d 1206, 1207-08 (11th Cir. 1981).
195. At least one author has advocated legislation allowing basis increase when shareholders guarantee corporate debt. See I. Grant, supra note 12, § 19.7, at 19-24.
196. The Commissioner, rather than taxpayers, has most often relied on the substance over form doctrine in arguing that loan guarantees should be recharacterized as capital contributions. See *Plantation Patterns*, 462 F.2d at 721; *Murphy Logging Co.*, 378 F.2d at 224; Santa Anita Consol., Inc. v. Commissioner, 50 T.C. 536, 548 (1968). But see J.A. Maurer, Inc. v. Commissioner, 30 T.C. 1273, 1289 (1958) (petitioner-corporation urged recharacterization).
197. 778 F.2d at 774-75.
198. The federal circuits have developed their own sets of factors for determining whether
Treasury promulgate new debt-equity regulations,199 the tests could easily adapt to such regulations.

Selfe also correctly states that the basis of indebtedness of the corporation to the shareholder should increase when facts demonstrate that the guarantee resembles a loan from the bank to the shareholder that is followed by a loan from the shareholder to the corporation.200 This view comports with the spirit, although not the letter, of section 1366(d)(1)(B). Congress intended the subchapter S loss limitation to be the theoretical equivalent of an investment in the corporation,201 whether the shareholder chose to accept the stock of the corporation under section 1366(d)(1)(A) or the corporation's debt under section 1366(d)(1)(B).202 Courts have interpreted this legislative intent so as to require that an economic outlay precede basis generation.203 When a shareholder pledges assets as security for the guaranteed loan, the shareholder loses the availability of those assets as collateral for other investments. The shareholder thus loses the time value or use of the collateral. The shareholder also forgoes potential earnings on an additional investment that could be made absent the pledge. Under these circumstances the shareholder does, in fact, experience an economic outlay. The shareholder has thus made the requisite investment in connection with the corporation, in the form of forgone revenue, time value, and use of collateral.204

Allowing basis generation in indebtedness when a shareholder guarantees corporate debt would also further harmonize S corporation provisions with partnership provisions, an announced goal of the Subchapter S Revision Act of 1982.205 Allowing basis increase also would remove another trap for unwary shareholders who, had they retained tax counsel, simply would have restructured the transaction by personally borrowing funds, then loaning the funds to the corporation. Congress clearly intended to remove harsh traps for unwary taxpayers from the purview of subchapter S.206

The Selfe decision was not correct in all respects, however. Although the Selfe court correctly stated that debt-equity principles should control in determining an increase in stock basis, the court illogically reasoned that the

corporate debt constitutes debt or equity for tax purposes. See supra notes 117-35 and accompanying text.

199. The 1980 Treasury Regulations establishing national debt-equity guidelines were withdrawn in 1983. See supra notes 129-35 and accompanying text. Some commentators have suggested that Congress may altogether scrap the notion of establishing national debt-equity guidelines and repeal § 385. B. BITTKER & J. EUSTICE, supra note 118, ¶ 4.05, at 54-10 (Supp. 1984).

200. 778 F.2d at 774.


204. The Eleventh Circuit voiced similar views. See Selfe, 778 F.2d at 772-73 n.7.

205. S. REP. NO. 640, supra note 18, at 6, 1982 U.S. CODE CONG. & ADMIN. NEWS at 3258.

206. Id.
same debt-equity principles should be used to test a potential increase in the basis of indebtedness.\textsuperscript{207} Indebtedness, unlike stock, is simply not equity to which guaranteed debt can be converted. Moreover, unlike using debt-equity principles to test for increase in stock basis, extension of debt-equity principles to basis of indebtedness lacks precedential authority.\textsuperscript{208}

A proper set of requirements for testing addition to the basis of indebtedness would first require that the shareholder adequately secure the debt with collateral. This requirement would insure that the transaction meets the economic outlay requirement of S corporation basis. A second requirement should be that the shareholder guaranteed the debt at the request of the lender. This requirement would preclude shareholders from obtaining a basis increase by volunteering a guarantee when the lender would not otherwise require one. Congress also should require that the guarantee result in absolute, or unconditional, liability\textsuperscript{209} to the shareholder under the terms of the guarantee contract, or under applicable state law, whichever applies.\textsuperscript{210} Any basis increase requires a firm dollar figure for purposes of computing the loss limitation. Shareholders who have unconditional liability can affix a dollar amount on the value of the guarantee for which they are economically at risk. If the guarantee is not absolute, the dollar value of the guarantee is not readily ascertainable, since state law or the guarantee contract may first require the creditor to proceed against the principal debtor. Finally, for a shareholder guarantee to increase the basis of indebtedness, the guaranteed debt should be of a type that would generate basis under partnership provisions. This requirement would preclude shareholders from receiving tax treatment more favorable than partnership provisions would allow. For example, partnership provisions disallow basis increase for secondary liability of the partnership\textsuperscript{211} and for nonrecourse liabilities of the partnership.\textsuperscript{212}

\begin{footnotesize}
\textsuperscript{207} 778 F.2d at 774-75. For purposes of the loss limitation of § 1366(d), distinguishing stock basis and indebtedness basis is insignificant. Other tax consequences, however, demonstrate the need for specifying whether the guarantee constitutes an addition to stock basis or an addition to the basis of indebtedness. For example, repayment of debt by the corporation to the shareholder results in income to the shareholder if such basis has been previously reduced. Rev. Rul. 64-162, 1964-1 C.B. 304. Whether the guarantee increases stock basis or indebtedness basis can therefore affect the amount of income to the shareholder. For a discussion of the consequences of repayment of debts to shareholder-creditors, see J. Eustice & J. Kuntz, supra note 1, § 9.08.

\textsuperscript{208} The precedents in this area applied debt-equity principles to determine whether to recast a guarantee as a capital contribution. See supra notes 136-78 and accompanying text. No case has applied debt-equity principles to determine whether to recast a guarantee as a loan from the shareholder to the corporation.

\textsuperscript{209} If the guarantee is unconditional or absolute, the shareholder's liability depends only upon the default of the principal debtor. 38 AM. JUR. 2D Guaranty § 21 (1968). Liability under a conditional guarantee arises only upon the happening of some event other than the principal debtor's default. Id.

\textsuperscript{210} In some states, such as California, a guarantor's liability is presumed unconditional by statute. CAL. CIV. CODE § 2806 (West 1974). That statute addresses suretyship, but § 2787 of the California Code abolishes guarantee-suretyship distinctions. Id. § 2787. Absent a state statute, the triggering of the guarantor's liability depends upon the construction of the guarantee contract. 38 AM. JUR. 2D Guaranty § 108 (1968).

\textsuperscript{211} A partner's contribution of encumbered property does not result in partnership liability that would increase the partners' bases. I.R.C. § 752(a) (1986). Similarly, partners do not receive increased basis when the partnership is a guarantor or a surety for the liabilities of
\end{footnotesize}
The overall effect of the foregoing suggestions would harmonize the economic outlay requirement for basis generation with the announced goal of closing the gap between subchapter S provisions and partnership provisions. An amended section 1366(d) incorporating the recommendations might resemble the following (proposal in italics):

(d) Special rules for losses and deductions.
(1) Cannot exceed shareholder’s basis in stock and debt. The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of—
   (A) the adjusted basis of the shareholder’s stock in the S corporation . . . , and
   (B) the shareholder’s adjusted basis of any indebtedness of the S corporation to the shareholder . . . .

(4) Shareholder loan guarantees. A shareholder who guarantees debt of the S corporation shall increase the basis of—
   (A) stock specified in subparagraph (A) of paragraph (1) of this subsection, if the guarantee constitutes, in substance, a contribution to the capital of the S corporation, demonstrated if—
      (i) the lender looked primarily to the shareholder for repayment of the debt at the time of the guarantee; and
      (ii) the guarantee would be considered an equity investment in the corporation under applicable debt-equity principles; or
   (B) indebtedness of the corporation specified in subparagraph (B) of paragraph (1) of this subsection, if—
      (i) the shareholder pledges adequate collateral as security for the debt;
      (ii) the shareholder guaranteed the debt at the request of the lender;
      (iii) the guarantee is absolute, or unconditional, according to the guarantee contract or applicable state law, if any; and
      (iv) the debt would result in increased basis under applicable partnership provisions.

(5) Guarantee defined. The term guarantee shall include, but not be limited to, suretyship, comaking, indemnity, and indorsement arrangements.

(6) Authority to prescribe regulations. The Secretary shall prescribe such regulations as are necessary to determine whether a shareholder has pledged adequate collateral as security for the guaranteed debt under subparagraph (B)(i) of paragraph (4) of this subsection.

VI. Conclusion

The Internal Revenue Code limits losses and deductions that pass through


212. The at-risk provisions of § 465 limit the partnership loss limitation to amounts for which partners are personally liable. I.R.C. § 465(b)(1)(A) (1986).
to S corporation shareholders by the sum of the adjusted basis in the shareholder's stock and the adjusted basis of any indebtedness of the corporation to the shareholder. Shareholders who guarantee debt of their S corporations have long argued unsuccessfully that their guarantee should increase their basis in the corporation. In December 1985 the Eleventh Circuit, citing Fifth Circuit precedent, decided Selfe v. United States and held that a shareholder who guarantees corporate debt may increase basis in either stock or indebtedness if the lender primarily looked to the shareholder for repayment for debt, and if application of traditional debt-equity principles would reveal that the guarantee constituted a capital contribution in substance. Selfe's holding is well reasoned with respect to equity, but precedent does not support Selfe's conclusion with respect to indebtedness. Still, valid reasons exist for allowing an increase in basis of indebtedness when the guarantee arrangement meets certain requirements. These requirements are that the shareholder pledge adequate collateral for the debt, that the shareholder guarantee the debt at the request of the lender, that the guarantee be absolute or unconditional, and that that the debt would result in increased basis under partnership provisions. Congress should amend section 1366(d) of the Internal Revenue Code to incorporate the foregoing suggestions.