**Passthrough Partner**

*Broz v. Commissioner*: How Not to Structure Back-to-Back Loans to an S Corporation

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In *Broz v. Commissioner*, the Sixth Circuit affirmed the Tax Court’s finding that a purported back-to-back loan arrangement did not constitute “bona fide indebtedness” between an S corporation shareholder and the S corporation itself. Accordingly, all of the taxpayer’s deductions with respect to the S corporation’s losses were disallowed under the basis limitation of Code Sec. 1366(d) for the tax years at issue.¹

The Sixth Circuit decision and the Tax Court decision it affirmed are noteworthy for at least two reasons. First, both decisions clearly held that the taxpayer’s post facto efforts to insert himself as an intermediary between an unrelated third-party lender and the S corporation borrower, in which he was the 99-percent shareholder, through the use of promissory notes and journal entries did not establish *bona fide* indebtedness. The determination of whether a funding arrangement constitutes *bona fide* indebtedness is not an uncommon source of disagreement between taxpayers and the government, especially in the context of partnerships and S corporations. Two recent sets of proposed regulations reflect the government's focus on debt classification and related basis issues.

In June 2012, the Treasury and the IRS proposed amendments to Reg. §1.1366-2 requiring that in order to create debt basis in an S corporation, the purported indebtedness of such S corporation to its shareholder must constitute “bona fide indebtedness ... that runs directly to the shareholder.”¹ The recently published Proposed Regulations under Code Sec. 752 also reflect the government’s attempt to provide
a framework, albeit highly controversial, for ensuring that only *bona fide*, commercial payment obligations are given effect under Code Sec. 752.\(^5\) The authors will analyze the Code Sec. 752 Proposed Regulations in a subsequent article.

Returning to the Proposed Regulations under Code Sec. 1366(d), the preamble expressly acknowledged the frequency of disputes between S corporation shareholders and the government regarding whether certain loan transactions involving multiple parties, including back-to-back loan transactions, create debt basis for purposes of Code Sec. 1366(d)(1)(B), of which *Broz* would be illustrative.\(^6\)

As a result of holding that *Broz* did not have sufficient debt basis under Code Sec. 1366(d) to claim the flow-through losses during the tax years at issue, the Sixth Circuit did not address the second loss limitation issue in the case—whether the taxpayer’s pledge of stock in a related S corporation caused the taxpayer to be at risk, for purposes of Code Sec. 465.\(^7\)

Although the Sixth Circuit’s decision not to address the at-risk issue is correct, the Tax Court, nevertheless, had analyzed this issue in its earlier decision. It held that *Broz*’s pledge of stock did not put him at risk in the S corporation from which he sought to recognize losses, which brings us to the second noteworthy takeaway point from this case.\(^8\)

According to the Tax Court, the technical issue of whether stock pledged in a related S corporation is used in the business of the borrower and therefore precludes the pledging taxpayer from being considered at risk with respect to the borrowed amount was an issue of first impression.\(^9\) As discussed more fully below, notwithstanding the Sixth Circuit’s correct decision to punt on this question, the Tax Court’s analysis on this issue is nevertheless instructive and should not be overlooked.

**Overview of S Corporation Shareholder Basis in Indebtedness**

When advising clients with respect to choice of entity issues, one of the most obvious differences between a partnership and an S corporation is the treatment of partner/shareholder basis in entity-level indebtedness.\(^10\) Along those lines, perhaps the most significant advantage of a partnership over an S corporation in the context of a leveraged trade or business or investment, such as real estate, is that an increase in a partner’s share of entity-level debt is treated as a contribution of money and therefore increases such partner’s basis in his partnership interest.\(^11\)

This increase in outside basis enhances the partner’s capacity to recognize flow-through losses\(^12\) (assuming the at-risk\(^13\) and passive activity loss\(^14\) limitations do not apply), absorb distributions of money without triggering gain,\(^15\) and reduce the amount of gain (or increase the amount of loss, as the case may be) recognized on the sale or exchange of the partnership interests.

Subchapter S, on the other hand, does not treat entity-level debt in the same manner, unless the debt runs directly from the S corporation to the shareholder. The partnership debt allocation rules in Reg. §1.752-2 (recourse liabilities) and §1.752-3 (nonrecourse liabilities) do not have a corollary in subchapter S. Under Code Sec. 1366(d)(1), the total amount of losses and deductions that a shareholder may take into account for any tax year cannot exceed the sum of that shareholder’s:

1. adjusted basis in the stock of the S corporation, and
2. adjusted basis of any indebtedness of the S corporation to such shareholder.

Thus, unlike a partnership in which a partner’s outside basis includes both his capital investment and his share of partnership-level debt, entity-level debt of an S corporation does not create either stock or debt basis for a shareholder, unless the shareholder is the creditor. Moreover, a shareholder’s guarantee of entity-level debt does not create debt basis for purposes of Code Sec. 1366(d); whereas, in a partnership context, a partner’s guarantee of entity-level debt can attract a higher allocation of debt for purposes of Code Sec. 752 and even the at-risk rules of Code Sec. 465.\(^16\)

This difference in the treatment of entity-level debt creates a point of friction in tax planning for S corporation shareholders that can lead to unusual funding arrangements, such as the structure in *Broz*, that attempt to generate debt basis under Code Sec. 1366(d).
1366(d) for a shareholder in a manner that would accomplish the same result, from both an economic risk and tax perspective, as if the S corporation were a partnership for federal tax purposes.

**Funding Arrangement in Broz**

As noted above, the Sixth Circuit in *Broz* affirmed the Tax Court’s determination that the taxpayer did not have sufficient debt basis to claim the flow-through losses.

**A. Factual Background**

Broz incorporated RFB Cellular, Inc. ("RFB") in 1991 to hold an FCC license to operate a cellular network in Northern Michigan. For federal income tax purposes, RFB was treated as an S corporation. In the mid-to-late 1990s, Broz expanded RFB’s existing cellular business to new license areas. To fund the expansion, RFB’s lenders required it to form a new entity to hold the FCC license and the debt. To that end, the taxpayer incorporated Alpine PCS, Inc. to bid on FCC licenses and to construct and operate digital networks; Broz owned 99 percent of Alpine PCS, and his brother owned the remaining one percent. RFB and commercial lenders funded the bidding and constructed and operated the new networks. For federal income tax purposes, Alpine PCS was treated as an S corporation.

Alpine PCS successfully bid on 12 FCC licenses between 1996 and 2001. It made down payments on the licenses and issued notes payable to the FCC for the balance of the purchase prices. Alpine PCS then transferred the licenses to various single-member LLCs formed to hold the licenses and lease them back to Alpine PCS. Identical to the ownership of Alpine PCS, Broz held a 99-percent membership interest in each license holding LLC and his brother owned the remaining one-percent interest. Each license holding LLC assumed the FCC debt in exchange for receiving the license from Alpine PCS. Notwithstanding such debt assumption, Alpine PCS, not the license holding LLCs, continued to make payments on the FCC debt.

CoBank was the main commercial lender for RFB and the Alpine entities during the tax years at issue. RFB used the loan proceeds to expand its existing business through Alpine PCS and the related entities. CoBank specifically acknowledged that RFB would advance the proceeds directly or indirectly to the Alpine entities. The CoBank loan was secured by the assets of the license holding LLCs. Broz also pledged his RFB stock as additional security but did not personally guarantee the CoBank loan.

RFB recorded the advances on its general ledger as “advances to Alpine PCS” and Alpine PCS recorded the same advances as “notes payable.” Some of the advances to Alpine PCS were allocated to other Alpine entities, which, in turn, recorded such allocations as “notes payable” on their respective general ledgers. RFB, Alpine PCS and the other Alpine entities made year-end adjusting journal entries reclassifying the advances as shareholder loans.

Promissory notes then were executed between Broz and RFB and between Broz and Alpine PCS to reflect accrued but unpaid interest on the purported loans. RFB indicated in financial statements for the tax years at issue that it would not demand repayment on any of the advances, and no security was provided by Broz with respect to these promissory notes. Although no cash payments of either principal or interest were ever made by any of the parties with respect to the promissory notes, Broz reported interest income and interest expense from the promissory notes on his individual returns.

Beginning in 1999, the advances from RFB were reclassified through year-end adjusting journal entries as loans from Alpine Investments, LLC, a single-member LLC wholly owned by Broz. Alpine Investments assumed the promissory notes executed between Broz and Alpine and between Broz and RFB. Alpine Investments, in turn, executed promissory notes with other Alpine entities and RFB to document the purported loans.

The Sixth Circuit summarized the recurring transactions by which Alpine PCS received funding as consisting of the following three steps:

1. RFB obtained a loan from CoBank.
2. RFB advanced the CoBank loan proceeds to Alpine PCS.
3. Using year-end accounting adjustments and post-dated promissory notes, Broz recharacterized the second part of the transaction as if the CoBank loan proceeds were advanced from RFB to Broz and then loaned by Broz (or Alpine Investments) to Alpine PCS.

**B. No Debt Basis**

In concluding that the Alpine entities were not directly indebted to Broz and therefore did not have sufficient debt basis to claim flow-through losses, the Tax Court noted that he did not substitute himself as the lender in the place of RFB and no payments...
were made on the advances. The Tax Court characterized the CoBank loan as running from RFB to the Alpine entities, with Broz serving as a mere conduit for the funds.  

The Sixth Circuit affirmed the Tax Court’s determination that the purported back-to-back loan arrangement did not establish *bona fide* indebtedness between Broz and Alpine PCS. How and when the parties accounted for and documented the purported loans were key factors for both courts that undermined the taxpayer’s position that such loans created debt basis in Alpine PCS. Specifically, the Sixth Circuit noted that:

Broz’s use of journal entries and promissory notes to insert himself into an already-completed transaction establishes only that he became the guarantor of the debt that already ran from Alpine PCS to RFB. This guaranty does not give Broz the debt basis in Alpine PCS necessary to deduct the S corporation’s losses, because a taxpayer’s guarantee and pledge of assets, without more, do not establish indebtedness of the S corporation to the shareholder.  

Similarly, a few paragraphs later in the opinion, the Sixth Circuit commented that “Broz’s post facto effort to insert himself as an intermediary did not increase his basis in Alpine PCS and is of no tax consequence.”

The courts’ focus in *Broz* on the inconsistent and after-the-fact journal entries and documentation of the purported back-to-back loan structure should be a clear reminder to S corporations, shareholders and their advisors that adhering to the form of the structure is critical to withstanding governmental scrutiny. Broz would have been in a much better position to defend his recognition of the flow-through losses from Alpine PCS if he had followed this checklist:

- **Funds Follow Back-to-Back Loan Structure.** Deposit the CoBank loan proceeds in Broz’s personal bank account and then loan money to Alpine PCS memorialized by a contemporaneously executed promissory note with an interest rate and payment terms not more favorable than the CoBank loan and with appropriate collateral securing the debt.
- **Account for the Loan as a Shareholder Loan.** Alpine PCS should have accounted for the receipt of cash from Broz by recording a credit to “Shareholder Loan” on its general ledger with appropriate treatment as a liability on its balance sheet.
- **Make Payments.** The failure of Alpine PCS to make payments of either principal or interest undermines the treatment of the advances as *bona fide* indebtedness.

Broz could not check off any of the above boxes—he was not a borrower or co-borrower on the CoBank loan; the CoBank loan proceeds moved from RFB to Alpine PCS; RFB accounted for the advances to Alpine PCS as an asset on its balance sheet; no cash payments were made on the purported back-to-back loans. The failure of the taxpayer to follow the form of the back-to-back loan structure he attempted to create undermined his claim of basis in the CoBank loan proceeds.

### C. At-Risk Limitation

The second noteworthy passthrough tax issue in this case concerns whether Broz’s pledge of RFB stock caused him to be at risk, for purposes of Code Sec. 465, in Alpine PCS and the other Alpine entities. Although a pledge of personal property as security for borrowed amounts can be included in the at-risk amount, Code Sec. 465(b)(2)(B) carves out the pledge of any property used in the activity for which such borrowed funds are being used. The Tax Court rejected the taxpayer’s argument that the pledged RFB stock was not property used in the business at-risk purposes because the Alpine entities were formed for the purpose of expanding RFB’s existing cellular networks.  

The court also observed that even if the pledged RFB stock was treated as unrelated to the cellular

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phone business, the taxpayer still was not actually at risk with respect to the Alpine entities. Broz had not personally guaranteed the CoBank loan and was not personally liable on the purported loans to the Alpine entities. In the Tax Court’s view, the purported back-to-back loan had been structured in such a way that it was highly unlikely that Broz himself would suffer a loss.

Recall that the Sixth Circuit did not address the at-risk issue because the court considered it to be unnecessary after affirming the Tax Court’s holding that Broz did not have sufficient debt basis to absorb the losses from Alpine PCS under Code Sec. 1366(d).

Proposed Regulations Under Code Sec. 1366

On June 11, 2012, the Treasury and the IRS issued Proposed Regulations dealing with the often-disputed issue of whether a shareholder has debt basis for purposes of Code Sec. 1366(d)(1)(B). As noted above, the Proposed Regulations clearly state that in order to increase a shareholder’s debt basis, the loan must represent “bona fide indebtedness of the S corporation that runs directly to the shareholder.”

A. No Actual Economic Outlay Required

Although the Proposed Regulations do not shed any light on what constitutes “bona fide indebtedness,” the preamble clarified that an S corporation shareholder is not required to satisfy the “actual economic outlay” doctrine to create debt basis.

The ABA Tax Section comments on the Proposed Regulations rightly recommend that the regulations themselves, not just the preamble, should be equally clear on this point. Perhaps, Proposed Reg. §1.1366-2(a)(2)(i) should be modified as follows upon finalization to include the italicized clause below:

(i) In general. The term basis of any indebtedness of the S corporation to the shareholder means the shareholder’s adjusted basis (as defined in §1.1011-1 and as specifically provided in section 1367(b)(2)) in any bona fide indebtedness of the S corporation that runs directly to the shareholder, regardless of whether the shareholder has made an actual economic outlay provided that the shareholder has been made poorer in a material sense as a result of the loan.

The italicized language was pulled from the preamble.

The Proposed Regulations also left unchanged the conclusion in Rev. Rul. 81-187 that a shareholder of an S corporation does not increase its stock basis upon the contribution of the shareholder’s own unsecured demand note to the corporation.

B. Shareholder Guarantee Does Not Increase Basis in Indebtedness

The Proposed Regulations clearly provide that an S corporation shareholder does not obtain debt basis credit merely by guaranteeing a loan or acting as a surety, accommodation party or in any similar capacity relating to a loan. When a shareholder makes a payment on bona fide indebtedness for which the shareholder has acted as a guarantor or in a similar capacity, the shareholder may increase his debt basis to the extent of such payment.

C. Incorporated Pocket Theory Examples

The Proposed Regulations included two examples (Examples 3 and 4) dealing with variations on the “incorporated pocketbook” theory in which a shareholder’s debt basis increases upon a loan to the S corporation from an entity related to the shareholder. In these types of transactions, an S corporation shareholder claims that a transfer from a related entity directly to the shareholder’s S corporation was made on the shareholder’s behalf and is, in substance, a loan from the related entity to the shareholder, followed by a loan from the shareholder to the S corporation.

Both of the examples below from Proposed Reg. §1.366-2(a)(2)(iii) assume away the deciding issue in Broz, which is whether the purported loan structure actually constitutes “bona fide indebtedness.”

Example 3 (Back-to-Back Loan Transaction). A is the sole shareholder of two S corporations, S1 and S2. S1 loaned $200,000 to A. A then loaned $200,000 to S2. Whether the loan from A to S2 constitutes bona fide indebtedness from S2 to A is determined under general federal tax principles and depends upon all of the facts and circumstances. If A’s loan to S2 constitutes bona fide indebtedness from S2 to
A, A’s back-to-back loan increases A’s basis of indebtedness in S2.

Example 4 (Loan Restructuring Through Distributions). A is the sole shareholder of two S corporations, S1 and S2. In March 2013, S1 made a loan to S2. In December 2013, S1 assigned its creditor position in the note to A by making a distribution to A of the note. Under local law, after S1 distributed the note to A, S2 was relieved of its liability to S1 and was directly liable to A. Whether S2 is indebted to A rather than S1 is determined under general federal tax principles and depends upon all of the facts and circumstances. If the note constitutes bona fide indebtedness from S2 to A, the note increases A’s basis of indebtedness in S2.

Concluding Thoughts on Bona Fide Indebtedness

Broz and the Proposed Regulations under Code Sec. 1366(d) should be read together. Examples 3 and 4 in the Proposed Regulations plainly illustrate that the IRS does not view back-to-back or intercompany-loan structures as inherently failing to create debt basis. These examples, however, assume without further elaboration that the debt is indeed bona fide indebtedness. Broz fills this gap in the Proposed Regulations by addressing head-on whether a funding arrangement among related S corporations and their common shareholder constitute bona fide indebtedness. More specifically, Broz illustrates how not to structure a purported back-to-back loan arrangement if the goal is to create debt basis for an S corporation shareholder.

ENDNOTES

1 R. Broz, CA-6, 2013-2 ustc ¶ 50,488, 727 F3d 621.
2 Unless otherwise indicated, all “Code Sec.” references are to the Internal Revenue Code of 1986, as amended, in effect at the time of publication.
5 79 FR 4826 (Jan. 30, 2014).
7 Broz, supra note 1, 727 F3d, at 628.
8 Broz, 137 TC 46, 64, Dec. 58,750 (2011).
9 Id., 137 TC, at 47.
10 Any reference to a partnership or an S corporation includes any entity classified as such for federal tax purposes. Also, any reference herein to a shareholder of an S corporation shall also include a member of a limited liability company, whose members have elected to be classified as an S corporation for federal tax purposes.
11 See Code Secs. 752(a), 722 and 705.
12 Code Sec. 704(d).
13 Code Sec. 465.
14 Code Sec. 469.
15 Code Sec. 731(a)(1).
16 In CCA 201308028 (Nov. 14, 2012), the IRS Office of Chief Counsel distinguished between the at-risk treatment of a guarantee by a limited partner and member. The rationale for the distinction was that a limited partner who makes a payment to a creditor on partnership-level debt due to a guarantee may have a claim for reimbursement from the general partner; whereas, a member of an LLC generally does not have a similar opportunity under state law because there is no general partner equivalent.
17 Given this state law difference, the CCA concluded that an LLC member, who guarantees entity-level debt, will be treated as at-risk, under Code Sec. 465, with respect to the guaranteed debt, even if the member/guarantor does not completely waive his rights of subrogation and reimbursement from the LLC, so long as the guarantee is bona fide and enforceable by the creditor against the member/guarantor under local law, and the member/guarantor is not otherwise protected against loss. This CCA provided a long overdue and much welcomed clarification that Proposed Reg. §1.465-6(d)—which was promulgated in 1979, well before the advent of LLCs—did not apply to a member/guarantor.
18 Id., supra note 8, 137 TC, at 63.
20 Id.
21 Broz, supra note 8, 137 TC, at 63–64.
22 Id., at 64.
23 Id.
25 ABA Tax Section Comments on Proposed Rules (REG-134042-07) on Basis Increases on Loans to S Corporations by Shareholders (Sept. 18, 2012).
26 1981-2 CB 167.