Originally published in the:
New York Law Journal ***February 15, 2024***

Intercompany Loans Recharacterized: 'Fry v. Commissioner'

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When business activities are conducted through two or more corporations under common ownership, one such corporation will frequently be funded, directly or indirectly, with cash from the other. The manner in which funds are transferred from the corporation with available cash (ProfitCo) to the corporation with cash needs (LossCo) can affect the tax treatment of the corporations and their shareholders.

If the corporations involved are S corporations, the preferred structure for the flow of funds may be influenced by IRC section 1366(d), which generally limits the pass-through of losses to an S corporation shareholder to the aggregate of the shareholder's basis in stock of the corporation and the shareholder's basis in loans made by the shareholder to the corporation. If funds are withdrawn from ProfitCo as a distribution with respect to stock and then contributed to LossCo by the shareholder, the amounts so contributed will be taken into account in determining the extent of losses of LossCo that may be taken into account by the shareholder. A similar result will generally apply if ProfitCo lends funds to the shareholder and the shareholder then makes loans to LossCo. However, if funds are lent directly from ProfitCo to LossCo, the funds will not increase the shareholder's bases in stock and debt in LossCo.

In *Estate of Fry v. Commissioner* (TC Memo 2024-8), payments by one S corporation to, and for the benefit of, another S corporation under identical ownership were recorded as intercompany loans. Following issuance of a notice of deficiency premised on the shareholder's stock basis in the debtor corporation being insufficient to support the losses claimed by him, the petitioners were ultimately successful in persuading the Tax Court that the transfers should be recharacterized as distributions by one corporation to its shareholder, coupled with contributions by that shareholder to the other corporation.

FACTS IN *FRY*

Mr. Fry was the sole shareholder of two S corporations, Crown and CR Maintenance. Crown collected trash, recyclables, and other waste, and CR Maintenance processed that material into commodities sold to third parties. The businesses used the same facilities, and Mr. Fry received salary as an officer and rent payments from each corporation.

CR Maintenance ceased to be profitable by 2010, and its losses increased after the City of Los Angeles terminated a contract with it in 2011. Nonetheless, its business operations continued until the sale of most of the assets of Crown and CR Maintenance in 2015 for approximately $70 million.

From 2010 through 2013 (the year at issue), Crown provided funds to CR Maintenance ("Transfers") and made payments to CR Maintenance suppliers ("Payments") as needed to continue CR Maintenance's operations. Each Transfer was recorded on the books as a "Loan Payable," and each Payment was recorded as "Due from CR," but no promissory notes were delivered, no security interest in the assets of CR Maintenance was provided to secure the loans, and no interest charge was agreed upon or paid.

The court found that CR Maintenance intended to repay the Transfers and Payments to Crown if CR Maintenance became profitable. The loans were ultimately repaid by CR Maintenance to Crown by the end of 2020.

Mr. Fry and his spouse filed their joint Form 1040 for 2013 about a month after the extended due date of October 15, 2014, and claimed a flow-through loss from CR Maintenance of $4.7 million. Following audit, the IRS disallowed $3.5 million of that loss by reason of lack of basis of Mr. Fry in CR Maintenance, and asserted a tax deficiency with penalties for 2013.

DISCUSSION

The petitioners argued that the Transfers and Payments were not bona fide debt, that they should be characterized instead as constructive distributions by Crown to Mr. Fry and equity contributions by him to CR Maintenance, and that Mr. Fry therefore had sufficient basis to deduct almost all of the losses claimed on the petitioners' Form 1040.

The Commissioner asserted that, taking into account that the Transfers and the Payments had been consistently characterized by the corporations as debt, IRC section 385(c), the "duty of consistency," and the "doctrine of election" all prohibited the recharacterization of these amounts as constructive distributions and contributions.

Section 385(a) and (b) authorize the Secretary to issue regulations regarding factors to be taken into account in determining the treatment of interests in a corporation as stock or as debt. Section 385(c)(1) then states: "The characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest (but shall not be binding on the Secretary)."

Although section 385(c) also authorizes the Secretary to require such information as the Secretary deems to be necessary to carry out the purposes of the subsection, section 385(c)(1) by its terms appears to be self-operative even without regulations.

Regulations issued under section 385 in 2016 address issues concerning the treatment of interests in a corporation as stock or as debt "in particular factual situations" (Reg. § 1.385-1(a)), but do not apply by their terms to transactions involving S corporations; and the petitioners characterized the regulations and related preambles as indicating that section 385(c) was not intended to apply to S corporations.

The court agreed with petitioners' position that section 385(c) did not apply to the facts before the court, because there was "no formal issuance of any instrument evidencing the creation of an interest in stock or equity," such as a promissory note or stock certificate. The opinion also observed that section 385(c) "has never been applied to bind any taxpayer, much less an S corporation, to the initial characterization of an interest as equity or debt," and concluded that characterization of the Transfers and Payments as debt or otherwise should be made based on the overall situation and by reference to the factors generally cited in the case law in determining whether a transfer of funds to a corporation by a shareholder is debt or a contribution to capital.

The court then found that the preponderance of those factors favored treatment as equity, noting the absence of any interest payments or fixed maturity date, the circumstance that repayment was effectively contingent on the future profitability of a corporation incurring substantial losses, the absence of any collateral, and the likelihood of subordination to claims of regular creditors.

The opinion observed that, under the case law of the Court of Appeals for the Ninth Circuit (to which this decision would be appealable), constructive distribution treatment of a corporate expenditure is appropriate where the expenditure does not give rise to a deduction for the funding corporation and is primarily for the benefit of the shareholder. Both elements of this two-prong test were found to favor treatment of the Transfers and Payments as constructive distributions. No deduction was allowable to Crown for these payments, and the petitioners asserted that the payments resulted in shareholder benefits by facilitating the payments of rent and salary by CR Maintenance to Mr. Fry and reducing the need for Mr. Fry to fund CR Maintenance with personal funds. They also alleged that Crown would no longer be profitable if CR Maintenance ceased to operate.

In respect of the so-called "duty of consistency," the court found that under Ninth Circuit case law the elements that would have to be established to impose such a duty included: (i) a representation by the taxpayer, (ii) reliance by the Commissioner, and (iii) an attempt by the taxpayer to change its representation or recharacterize the situation in a manner that would be damaging to the Commissioner. The court agreed with the Commissioner that the returns of the corporations constituted representations satisfying the first element, and that the Commissioner relied on those returns, but found that the Commissioner failed to establish that the petitioners' position would result in an increased tax for any of the years before and after 2013 for which the statute of limitations had closed.

As to the "doctrine of election," the brief discussion in the opinion indicates that the court was not persuaded that the petitioners had (or were entitled to make) any "election" to treat the Transfers and Payments as debt or as equity. The opinion further observed that the Commissioner did not cite any case law of the Ninth Circuit showing that the doctrine had been adopted by the Ninth Circuit or would apply in this context.

OBSERVATIONS

The court's acceptance of the characterization by the petitioners of the Transfers and Payments as constructive distributions and contributions, after consistent treatment of the amounts on corporate records as debt, is noteworthy, especially in light of other cases (such as *Meruelo v. Commissioner*, 123 AFTR 2d 2019-1784 (11th Cir.), affirming TC Memo 2018-16, and *Shebester v. Commissioner*, TC Memo 1987-246) involving loans to S corporations where the taxpayers were essentially held to their form. The court's blithe dismissal of the IRS's arguments based on the plain language of section 385(c)(1) is also notable.

Another recent case of interest, *Huffman v. Commissioner* (TC Memo 2024-12), is arguably in line with *Fry* in showing at least some judicial willingness to accept characterizations by taxpayers of transactions that are arguably inconsistent with representations previously made by them. In *Huffman*, the principal issues were whether purchases of stock in a closely held corporation by a shareholder/executive from other shareholders, under agreements executed before the assets of the corporation were sold to a third party, resulted in taxable gifts, and whether the characterization of payments made by the buyer of the business to the shareholder/executive as being for personal goodwill was appropriate.

The *Huffman* opinion notes, in regard to the first issue, that the agreements under which family members agreed to sell their stock to the shareholder/executive stated that the agreements were not compensatory in nature, but rather intended to keep ownership of the corporation in the family; and a tax opinion obtained by the shareholder/executive in connection with those transfers apparently relied on those representations.

In regard to the gift tax consequences of the transfers of stock, however, the petitioners argued to the Tax Court, and the court agreed, that the agreements to transfer the stock were not a testamentary device, and that the transferors received full consideration for their shares, precisely because the shareholder/executive was prepared to work for a reduced salary in consideration of the enhanced profit potential associated with the transfers of shares to him, which certainly sounds like a compensatory motive. (At the end of the day, however, the court found that those agreements could not be relied upon as establishing a value for the shares.)

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