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Purported Loans Not Considered Debt

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Failure to document a transfer of funds between related parties as a loan may lead to the transfer's being characterized as something other than a loan for income tax purposes, notwithstanding the transferee's intent to repay the amount advanced. Indeed, even if a transfer is evidenced by a promissory note, failure to document the loan by the date of delivery of funds or to reflect in the documentation terms consistent with ordinary business practice in arm's length dealings between a lender and a borrower may result in an advance's being characterized as something other than a loan for tax purposes, to the potential disadvantage of the purported lender or borrower. Two recent cases, *Keeton v. Commissioner*, 134 AFTR 2d 2024-5992 (9th Cir.), affirming TC Memo 2023-35, and *Feathers v. Commissioner*, TC Memo 2024-88, illustrate these points.

Keeton

In *Keeton*, the petitioners (married individuals) and another couple each owned 50% of a limited liability company (KRLLC) that was classified as a partnership for tax purposes and had been formed to invest in real estate and other projects. KRLLC had no business operations of its own during 2017 and 2018, the years at issue. The members of KRLLC were also the controlling shareholders of a corporation (IWS) that was incorporated in 1994 to operate a landfill in Idaho.

IWS had little capital, and its operations were funded by the members of KRLLC through numerous transfers to IWS. These transfers were recorded on the books of KRLLC under a register captioned "Due from IWS." Many of the entries in that register were captioned as "capital" or as "Investment — [IWS]." The aggregate balance of that register, at its peak in 2007, was approximately $7.4 million.

In 2007, IWS entered into an arrangement with a bank to obtain a bond required by the state government and a $2.5 million line of credit, secured by a deed of trust on its landfill property. Thereafter, no further funds were provided to IWS through KRLLC.

IWS, through its President, executed a one-page unsecured promissory note in 2008 to pay $3.2 million to KRLLC "on demand," with interest at 9% per annum. An almost identical amount was entered on the year-end balance sheet of IWS for 2008 as a note payable to KRLLC, but this amount did not appear separately on the books of KRLLC, which continued to show an aggregate "Due from IWS" amount of $7.4 million. No consideration was received by IWS by reason of the execution of the note, and no interest payments under the note were recorded by KRLLC.

In 2010, the bank line of credit was repaid with funds obtained through a "bridge loan" of $4.2 million from an existing creditor of IWS. The $1.7 million of proceeds of the bridge loan that remained after payment of $2.5 million to the bank were remitted to KRLLC, and reflected on its "Due from IWS" register as reducing the balance due by $1.7 million, to $2.1 million. (The opinion does not indicate the adjustments to that register which apparently reduced the balance shown as due from $7.4 million at the end of 2007 to $3.8 million prior to reduction by the $1.7 million remittance to KRLLC.)

The bridge loan was due to be repaid in 2012. To strengthen the balance sheet of IWS in connection with efforts to find another lender to provide replacement financing, the shareholders of IWS entered into a Unanimous Written Consent dated January 1, 2012 (the Consent) that referenced loans made to IWS by its shareholders in the aggregate amount of $2.7 million of principal and $5.7 million of accrued interest. The shareholders resolved to eliminate those loans by converting the principal to paid-in capital and by canceling the obligation to pay interest.

Consistent with the Consent, the year-end balance sheet of IWS for 2012 showed no notes payable to its shareholders or to KRLLC. However, no corresponding entry was made in the "Due from IWS" register of KRLLC.

The search for replacement financing was unsuccessful, and the creditor under the bridge loan began foreclosure proceedings against IWS in 2017. Those proceedings resulted in a sale of the property in 2018, following which IWS was essentially moribund.

The partnership return of KRLLC for 2017 reported a bad debt deduction equal to the balance of its "due from IWS" register of $2.1 million. Petitioners' 50% proportionate share of that amount ($1.05 million) was reported on the Schedule K-1 issued by KRLLC to them. That loss was in turn reported on the petitioners' Form 1040 Schedule E for 2017, but with an explanation inconsistent with the circumstances relating to the bad debt deduction as described above and in the court's opinion.

Following an audit, the IRS disallowed the bad debt loss reported by the petitioners in 2017. The Form 886-A, Explanation of Items issued to KRLLC disallowed the $2.1 million bad debt deduction on the basis that "a bona fide debt did not exist" between KRLLC and IWS.

The petitioners challenged the resulting IRS notice of deficiency. Before the Tax Court, they argued that the Consent had not terminated the debt owed by IWS to KRLLC, because KRLLC was not a shareholder of IWS, and the Consent dealt by its terms only with loans by shareholders; and that the debt therefore continued to be outstanding until written off by KRLLC on its 2017 return. The Tax Court upheld the notice of deficiency, however, on two grounds.

The court found that the funds advanced through KRLLC were not debt to begin with. The court noted, among other circumstances, that: the funds advanced were not documented as a loan until a year after the final advance was made; the labeling of various advances on KRLLC records as "Investment — IWS" or "capital" was suggestive of capital contributions; the amount of the note executed in 2008 was far less than the investment in IWS shown on KRLLC records at the end of 2007, with no apparent reconciliation of the difference; the note lacked a fixed maturity date or payment schedule, and was neither secured nor guaranteed by any other party; and the evidence indicated that IWS was severely undercapitalized at all times and incurred substantial accumulated losses through 2007. Under those circumstances, a third-party lender would conclude that any payment by IWS of the interest stated in the note would be dependent on (highly uncertain) future earnings.

Further, and as a separate ground for the disallowance of the bad debt deduction, the court found that the Consent eliminated any debt that might otherwise have been owed by IWS to KRLLC as of the end of 2011. The petitioners admitted at trial that all of their advances to IWS were made through KRLLC, undermining their argument that the Consent was intended solely to forgive loans made directly by the shareholders. Based on this testimony, the text of the Consent, and corporate records, the court apparently declined to give credence to the petitioners' technical argument that the Consent did not apply to the loans purportedly made through KRLLC because KRLLC was not in form a shareholder of IWS.

The court also concluded that the petitioners could not avoid the addition to tax asserted by the IRS under IRC section 6662. The petitioners had contended that that the penalty should not be imposed because of their alleged reliance in good faith on advice of their accountant. However, the accountant who prepared returns for KRLLC and for the petitioners for the years at issue testified at trial that she was not informed of the Consent, which she admitted would have been relevant to her analysis as to whether a bad debt deduction was allowable, and she therefore lacked sufficient information to analyze the issue properly.

The petitioners appealed to the Court of Appeals for the Ninth Circuit, but that court affirmed the Tax Court decision in a memorandum opinion. The Court of Appeals determined that the Tax Court "did not clearly err" in concluding that the advances were not debt of IWS under the multi-factor test applied in the Ninth Circuit to distinguish debt from equity, or in concluding that the Consent eliminated any obligation that might otherwise have been owed to KRLLC by IWS. The Court of Appeals also upheld the addition to tax under IRC section 6662, observing that "[t]axpayers cannot rely on the advice of a professional when such advice was not based on knowledge of all of the facts."

Feathers

In *Feathers*, the petitioners (again married individuals) owned approximately 80% of the stock of a corporation (SBCC). SBCC in turn managed two funds (the Funds) formed to hold secured loans. The Funds' offering circular and private placement memorandum indicated that the Funds would pay to SBCC origination fees with respect to loans and management fees and reimburse SBCC for related expenses.

SBCC sought to obtain a Small Business Lending Company (SBLC) license from the Small Business Administration and caused one of the Funds to provide $750,000 in 2009 for the purchase of such a license. In 2010, an additional $1,850,000 was transferred from one of the Funds to SBCC, allegedly to pay for future expenses that SBCC might incur. These transfers were ultimately documented as loans in three notes executed in 2011, with one of the notes being secured by collateral.

The SEC investigated Mr. Feathers, and caused SBCC and the Funds to be placed in receivership. He was indicted in 2014 for various crimes and ultimately pleaded guilty to mail fraud.

Separately, the IRS examined the returns of SBCC -- an S corporation -- and the petitioners, and ultimately issued notices of deficiency to the petitioners for 2009 and 2010. In particular, the IRS asserted that the amounts received by SBCC from the Funds in those years, purportedly as loans, were instead unreported income of SBCC, and that the income passed through to the petitioners to the extent of their ownership percentage in SBCC.

Before the Tax Court, the petitioners asserted that the transfers at issue by the Funds to SBCC were loans and therefore not taxable to SBCC in the years received. The court ultimately agreed with the government, however, that there was no intent to create a bona fide debtor-creditor relationship between the Funds and SBCC when the transfers were made. The offering circular and PPM of the Funds prohibited loans to SBCC, and SBCC incurred substantial losses in 2009 and 2010 and was unlikely to ultimately be in a position to repay these amounts other than, possibly, from the highly speculative future income that might be generated from the SBLC license.

Of major importance to the analysis as to whether the advances were excludible from income as loans, in the view of the court, was that the notes were executed in 2011, one to two years after the amounts were transferred. Thus, during the years in which the amounts were transferred to SBCC, no collateral had been pledged to secure the alleged loans, and there was no documented agreement as to the interest rate to be charged or the date of repayment. The court concluded that, under all the circumstances, it was more likely than not that the transfers were not loans and upheld the IRS findings that the transfers resulted in income not reported by the petitioners.

Observations

The *Feathers* and *Keeton* cases are quite different from each other in respect of the nature of the underlying conduct of the taxpayers involved. However, each case underscores the need to ensure, where a transfer of funds is intended to be a loan, that loan documentation be executed by the time funds are transferred and include terms that a borrower and lender, acting at arm's length, might reasonably agree upon as the basis for a bona fide debtor-creditor relationship, and that are realistic under the circumstances. It is also highly desirable, and perhaps essential in certain contexts (*see* IRC section 385(c)), that the loan be consistently reflected as debt on the records of the creditor and debtor, especially where the parties are related.

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