Transactions Among Related Parties Are Subject To Heightened Scrutiny

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The IRS will strike down transactions among related parties that lack economic outlay. At least two recent US Tax Court cases are illustrative of the issue.

Kerzner

Kerzner v. Commissioner, T.C. Memo 2009-76 (April 6, 2009). The Service beat the taxpayers in this case by a nose. Mr. and Mrs. Kerzner were equal partners in a partnership that owned a building. The partnership leased the building to an S corporation which was owned equally by two shareholders, Mr. and Mrs. Kerzner. Over the years, the partnership loaned the Kerzners money. In turn, they loaned the money to their S corporation, which used the money to pay rent to the partnership.

At the end of each year, promissory notes were drafted to document the loans; some of the notes stated an interest rate, some did not. Even though the notes required payment of principal, virtually no payments were ever made because the notes each year were replaced with new notes before any payment was due.

The S corporation had large losses. The Kerzners claimed basis in the loans to the corporation and took the losses on their individual tax returns. Upon audit, the Service claimed the loans lacked economic substance and did not give the Kerzners basis to absorb the losses.

Two points of law need to be understood:

- First, in accordance with Code Section 1366(d)(1), the losses taken by the Kerzners cannot exceed their adjusted basis in the stock, plus their adjusted basis in any loans from them to the corporation; and
- Second, basis is only obtained in loans if: (i) the corporation owes the debt directly to the shareholders; and (ii) the shareholders really made an economic outlay that rendered them poorer. There must be economic substance-the loans must be real.

In this case, the money started with the partnership and ended with the partnership. Because it is likely no cash ever actually exchanged hands and only a mere after-the-fact paper trail was created, there was no economic substance. Consequently, the US Tax Court disallowed the losses.

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The Kerzners could have changed the result!

- They could have taken a real distribution from the partnership and loaned it to the S corporation, and required the corporation to make monthly payments of principal and interest;
- They could have borrowed money from a bank and loaned it to the S corporation, and required it to make monthly payments of principal and interest; or
- They could have used their own resources and loaned money to the S corporation and required it to make monthly payments.

Maguire

The 2012 tax court memo case of *Maguire v. Commissioner* sounds a lot like the saga of the Kerzners.

Like the *Kerzner* case, this is also a Tax Court Memorandum case. A Memorandum Opinion is generally only issued in a case that does not involve a novel legal issue. Like *Kerzner*, this case definitely did not involve a novel legal issue. Its outcome, however, is debatable.

While the facts and legal issues in this case are much like the *Kerzner* case, the outcomes are opposite.

Maguire v. Commissioner, T.C.M. 2012-160 (June 6, 2012). The Maguires, husband and wife, owned two S corporations. The businesses of the corporations were related. One corporation operated an automobile dealership. The other corporation operated a finance company that purchased customer notes from the dealership. The finance company operated at a profit while the automobile dealership operated at a loss. The Maguires did not have sufficient basis in the dealership to deduct the losses. They had substantial basis, however, in the finance company.

The Maguires could have fixed the problem. In a reorganization, they could have formed a parent holding company, an S corporation, and put the two corporations downstream as wholly-owned subsidiaries, and made QSub elections. This would have totally resolved the problem. Unfortunately, they had a minority owner in each entity that would not agree to the reorganization.

The Maguires came up with what they thought was the next best solution. At the end of each year, the finance company owned substantial A/R from the dealership. So, the Maguires caused the finance company to distribute the A/R to them; they had substantial basis to absorb the distribution without tax. Then, they contributed the A/R to the dealership, freeing up the losses with their newly found basis. The transactions were allegedly contemporaneously documented in minutes and the books of both corporations. The underlying customer notes were real and legally binding.

The Service disallowed the losses, arguing the actions between the related entities and the Maguires lacked any economic outlay. This was the same argument the government asserted in *Kerzner*. Although the transactions were documented by journal entries and corporate resolutions, the parties' economic positions were not altered.

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Losses deductible by a shareholder are limited to his or her basis in the corporation under Code Section §1366(d). A shareholder's basis in the corporation is increased by capital contributions. To qualify as a capital contribution, the shareholder must make an actual economic outlay. The US Tax Court disagreed with the IRS. Judge Ruwe found the "distributions and contributions did have real consequences that altered the positions of petitioners individually and those of their businesses." There was an economic outlay.

The court's decision hinged on several key facts, including:

- The transactions were properly memorialized in minutes of both corporations;
- The transactions were properly recorded in the books of both corporations;
- The underlying customer notes were real; and
- The accounts receivable were legally enforceable, and thus had value.

Conclusion

The facts in *Maguire* are strikingly similar to the facts presented to the court in *Kerzner.* The only real difference is that, in *Maguire*, there was credible evidence that the documentation was done contemporaneously with the transactions each year. Whether economic outlay exists is a question of fact. A few takeaways from *Maguire* and *Kerzner* relative to transactions among related parties include:

- Documentation is king. Transactions must be properly documented in the records of the related entities;
- The documentation should be contemporaneous with the transactions; after the fact documentation should be avoided;
- An actual transfer of funds should occur;
- The agreements need to have real consideration and be legally binding; and
- Caution is always required when transactions occur among related parties.

Kerzner and *Maguire* should serve as lessons for tax advisors. Transactions among related entities will be closely scrutinized. Economic substance must exist to withstand the attack.

Posted in Corporate Tax, Internal Revenue Service

Tagged as Corporate Tax, Economic Outlay, Kerzner, Maguire

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