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Never-Ending Limitations on S Corporation Losses: The Slippery Slope of S Corporation Debt Guarantees

Francine J. Lipman

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Introduction

In the Economic Growth and Tax Relief Reconciliation Act of 2001,\(^1\) Congress has made significant marginal tax rate cuts for individual taxpayers. As a result of these decreases, for the first time in years individual average income tax rates will be lower than corporate average income tax rates.\(^2\) Consequently, more taxpayers may consider organizing and operating their businesses using an entity that subjects income to one level of tax at the newly reduced individual income tax rates. Taxpayers seeking a business entity that combines one level of tax at the individual taxpayer level with limited liability generally choose between the S corporation and the limited liability company ("LLC").

One significant difference between the S corporation and the LLC is the amount of net operating losses that are allowed to pass through to each investor from the business entity. In a businesses’ start-up phase and during recessionary periods, such as the U.S. economy since March 2001,\(^3\) businesses often incur net operating losses. Investors in pass-through entities include anticipated tax benefits from pass-through net operating losses in their investment

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\(^1\) Pub. L. No. 107-16, 115 Stat. 38 (the “\textbf{2001 Act}”).

\(^2\) The corporate tax rate for taxable income levels between $335,000 and $10,000,000 is 34% and above $18,333,333 is 35%. The average tax rate increases from 34% to 35% at taxable income levels between $10,000,000 and $18,333,333. I.R.C. § 11(b). After the changes to the marginal individual income tax rates are fully-phased in by calendar year 2006 and thereafter, the highest individual marginal tax rate will be 35% at approximately $300,000 of taxable income with marginal tax rates of 10%, 15%, 25%, 28%, and 33% at lower taxable income levels. I.R.C. § 1 (as amended by 2001 Act Title I, Sec. 101).

analysis and decision-making process. Businesses desiring to attract and retain investors must maximize any tax benefits from their net operating losses. As a result, any limitations on pass-through net operating losses must be carefully considered and understood before management selects its business tax form or structures its transactions.

**S Corporation Loss Limitations**

Unfortunately, the limitations on pass-through net operating losses for S corporation shareholders are significant, complicated and have “sparked serious controversy and criticism in the last decade among practitioners, the judiciary, and the Internal Revenue Service” (the “Service”). S corporation shareholders have and continue to confront these limitations. Many shareholders and their tax advisors structure their S corporation transactions to attempt to fit within the guidance that allows current tax benefits for net operating losses. The resulting creative S corporation – shareholder debt structures often include variations of shareholder-level guarantees. The Service has contested successfully many of these structures because the courts have applied strict construction holding that S corporation shareholder basis allowing pass-through losses does not include any shareholder guarantee or any similarly characterized debt structures.

This article will discuss S corporation loss limitations in the area of shareholder guarantees focusing the analysis on the Tax Court’s and the Seventh Circuit Court of Appeals’ recent decisions in *Grojean v. Commissioner*. The article begins with a basic primer on the limitations for pass-through net operating losses for S corporation shareholders as compared to members in an LLC (or, similarly partners in a partnership). The primer includes a detailed

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5 *Grojean v. Commissioner*, 248 F.3d 572 (7th Cir. 2001), affg T.C. Memo 1999-425.
explanation of the absolute prohibition on S corporation loss basis for shareholder guarantees of S corporation debt. Next, the article discusses the Service’s and the courts’ strict scrutiny and tendency to find in a wide variety of alternative S corporation shareholder debt structures shareholder guarantees and disallow pass-through net operating losses. The article continues with a number of specific examples of debt structure recharacterizations including the recent case of Grojean v. Commissioner. The article analyzes the Seventh Circuit Court of Appeals’ esoteric and far-reaching economic discussion in the Grojean opinion. The court’s opinion demonstrates how courts may have a predilection to recharacterize shareholder debt structures as shareholder guarantees to deny shareholder basis. In Grojean, no one can deny that Justice Posner of the Seventh Circuit Court of Appeals aptly applies economic analytical tools to support his decision to ignore the form of a taxpayer’s structure and recharacterize the shareholder’s debt as a form of guarantee. However, the court also correctly admits that “[a]t high enough levels of abstraction . . . the difference between providing and enabling the provision of funding may disappear.” As a result, the substance of any differences between a lender and a guarantor may be meaningless and, therefore, any recharacterization unjustifiable. The article concludes with a brief summary of the lessons S corporation shareholders can learn from the Grojeans’ missteps.

**Introduction to Basic Rules for Loss Limitations: S Corporations**

S corporations and LLCs (and other entities subject to tax as partnerships) are pass-through entities, which generally do not pay any taxes at the entity level. All of the business income, gains, losses, deductions and credits are allocated among the owners of the business and

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6 Grojean v. Commissioner, 248 F.3d 572 (7th Cir. 2001), aff’g T.C. Memo 1999-425.
7 Grojean, 248 F.3d at 574 (citing Franco Modigliani & Merton H. Miller, “The Cost of Capital, Corporation Finance and the Theory of Investment,” 48 Am. Econ. Rev. 361 (1958)).
must be included in each owner’s annual tax calculation. A business’ net operating losses are allocated among and pass-through to each owner, but the amount of allowable net operating loss deduction may be limited at the owner level.9

A taxpayer’s share of a pass-through entity’s net operating losses is generally limited to the taxpayer’s investment in the business.10 A taxpayer’s business investment is measured by each owner’s tax basis. The measurement of tax basis for this purpose is different for a member of an LLC as compared to a shareholder in an S corporation. LLC members include their allocable share of indebtedness of the LLC in their tax basis.11 Therefore, the amount of allowable pass-through losses for any member of an LLC is increased by all LLC liabilities, which are properly allocable to such member.12

Comparatively, S corporation shareholders cannot include all of the S corporation liabilities in determining their allowable amount of pass-through net operating losses. An S corporation shareholder’s pass-through net operating losses are limited to her tax basis in her stock and any indebtedness of the S corporation to her.13 Liabilities of the S corporation to lenders other than shareholders (e.g., banks and other third-party lenders) are not included in the calculation for loss limitations. Even if shareholders personally guarantee these third-party loans, they do not receive any increase any allowable pass-through net operating losses.14 Any losses in excess of this limitation are suspended indefinitely until the shareholder has adequate

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8 S corporations that have been an S corporation since inception do not pay any entity level taxes. S corporations that were formerly C corporations may be subject to entity level taxes on any recognized built-in gains, any excess passive investment income and any LIFO inventory recapture. I.R.C. §§ 1374, 1375, 1363(d).
9 This article will be address owner level loss limitations such as the passive loss and at-risk rules. I.R.C. §§ 469, 465.
10 I.R.C. §§ 704(d), 1366(d)(1).
11 A member of an LLC determines her tax basis in her membership interest in the same manner as a partner in a partnership determines her tax basis in her partnership interest. I.R.C. §§ 722, 752(a).
12 Id.
stock basis and/or direct shareholder S corporation loans to recognize these losses.15 An S corporation shareholder’s suspended losses must be used by the shareholder when and if adequate stock basis or shareholder loans arise or will be lost forever. A shareholder’s suspended losses may not be transferred to a buyer through sale, or an heir or donee through devise or gift.16 Compared to LLCs and other entities characterized as partnerships, the shareholder level limitations on recognizable pass-through losses from S corporations may be significant if the S corporation has liabilities other than direct shareholder loans and extensive losses.

While shareholder level limitations on S corporation pass-through losses may be significant as compared to LLCs, S corporations remain a common business vehicle.17 Existing S corporations are numerous, because S corporations predate LLCs by a number of decades.18 Moreover, conversion of an S corporation into an LLC may have significant tax costs.19 Additionally, S corporations remain attractive because S corporation shareholders, unlike members in an LLC, can avail themselves of the benefits of the tax-free reorganizations provisions.20 Therefore, despite the shareholder level loss limitations for S corporations they remain an important entity choice. Accordingly, S corporations and their shareholders must

16 I.R.C. § 1366(d)(2); see also Tech. Adv. Memo 95-52-001 (interpreting I.R.C. § 1366(d)(2) as requiring losses suspended for insufficient basis to be personal to the taxpayer/shareholder, which cannot be transferred in any manner).
17 “According to the 1997 Statistics of Income (SOI) Bulletin data, the S corporation is now the most popular choice of business entity, representing 52.1 percent of all corporate entities. The SOI estimates that S corporations will increase at an annual rate of at least 4 percent.” WILLIAM H. HOFFMAN, JR., ET AL., CORPORATIONS, PARTNERSHIPS, ESTATES & TRUSTS 12-4 (West Fed. Tax’n 2002 ed.).
19 The conversion will be treated as a liquidation of the S corporation and the shareholders will have to recognize and pay tax on any appreciation in the S corporation’s assets. I.R.C. § 311(b).
20 I.R.C. § 368.
understand these loss limitations so that they can maximize any tax benefits from pass-through losses.

**Denial of Loss Basis for Shareholder Guarantees and Broadly-Determined Analogous Structures**

The ever-expanding denial of loss basis for shareholder guarantees is the focus of this article. The denial of loss basis for shareholder guarantees has evolved from case law and is particularly troubling because third-party lenders to loss S corporations often require shareholder guarantees for their loans. Because many S corporations are closely-held businesses, third-party lenders do not hesitate, especially when the S corporation is newly formed or generating significant losses, to ask for some form of security in addition to the assets of the S corporation.

Unfortunately, as common as this debt structure may be, shareholder guarantees of S corporation debt do not give rise to basis for loss limitation purposes. This now black-letter law was born in the courts. While academics have criticized this position, the Service has embraced it and has successfully disallowed S corporation shareholder pass through losses because of lack of any basis for guaranteed indebtedness.

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24 See *Brown v. Commissioner*, 706 F.2d 755 (6th Cir. 1983), aff’d 778 F.2d 769 (11th Cir. 1985) (applying debt-equity analysis to guaranteed loans to determine if shareholder’s debt was in substance equity).
The black letter law regarding S corporation shareholder guarantees is cited to and embodied by the Fourth Circuit Court of Appeals’ holding in *Leavitt*. The *Leavitt* decision holds that there is no basis increase for S corporation shareholder guarantees of S corporation debt absent a shareholder payment on the debt. In *Leavitt*, the Fourth Circuit, affirming the Tax Court, refused to accept an S corporation shareholder’s position that a third-party loan guarantee was in substance the shareholder’s equity in the S corporation. The *Leavitt* courts also refused to accept that the third-party loan was in substance the shareholder’s direct loan to the corporation providing basis. The Fourth Circuit determined that unless and until the shareholder made a payment on the guarantee, the shareholder would not receive any increase in shareholder tax basis for the shareholder guarantee.

Four years before the *Leavitt* opinion, the Eleventh Circuit Court of Appeals decided *Selfe v. United States*. In *Selfe*, the court held that an S corporation shareholder who issues a guarantee on S corporation debt is entitled to a basis increase “where the facts demonstrate that, in substance, the shareholder has borrowed funds and subsequently advanced them to the corporation.” The Eleventh Circuit continues to apply this analysis to shareholder guarantee loss basis cases, but only allows basis when the taxpayer has established that she is the borrower.

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26 Id.

27 This refusal has been followed by the Tax Court in all circuits except the 11th Circuit where *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985) (applying debt-equity analysis to guaranteed loans to determine if shareholder’s debt was in substance equity) supercedes *Estate of Leavitt*, 875 F.2d 420 (4th Cir.), cert. denied, 493 U.S. 958 (1989), aff’g 90 T.C. 206 (1988).

28 *Estate of Leavitt*, 90 T.C. at 211.

29 Id.

30 778 F.2d 769 (11th Cir. 1985).

31 Id. at 773.
and the primary obligor on the loan and she contributed the loan proceeds to the S corporation as capital. The Eleventh Circuit’s position is that it will allow basis if the shareholder can demonstrate that the guarantee is not in substance a guarantee, but rather a loan from the third-party lender to the shareholder followed by a capital contribution by the shareholder of the borrowed monies to the S corporation. No other circuit court of appeals follows the Eleventh Circuit’s analysis for shareholder guarantees. Moreover, the Tax Court has assessed negligence penalties and substantial understatement of tax penalties on taxpayers who have relied inappropriately, in its opinion, on Selfe.\(^{32}\)

The Service and courts vehemently apply the rule of law that a shareholder’s guaranty of an S corporation’s loan cannot be included as stock or indebtedness basis absent an economic outlay by the shareholder. The strength of this position has resulted in numerous recharacterizations of creative shareholder-S corporation debt-structures as “shareholder guarantees.” For example, in Technical Advice Memorandum 8426006,\(^{33}\) the Service ruled that shareholders did not obtain basis for being jointly and severally liable with their S corporation on a note to a bank, because the Service determined joint and several liability was equivalent to a shareholder guarantee. Moreover, the courts have held on numerous occasions that when an S corporation shareholder executes a bank loan as a co-maker with her S corporation, she does not obtain basis because she has merely guaranteed the S corporation’s indebtedness. The courts

\(^{32}\) See Briggs v. Commissioner. T.C. Memo 2000-380 (stating that these Eleventh Circuit taxpayers’ reliance on Selfe was misplaced and that the case was “so dissimilar that they must be discarded as providing no substantial authority for the tax returns filed in this case” citing Osteen v. Commissioner, 62 F.3d 356, 360 (11th Cir. 1995), revg. on this point T.C. Memo. 1993-510; Reser v. Commissioner, T.C. Memo 1995-572, aff’d in part, 112 F.3d 1258 (5th Cir. 1997); Keech v. Commissioner, T.C. Memo 1993-71; Nigh v. Commissioner, T.C. Memo 1990-349; but see Wise v. Commissioner, T.C. Memo 1997-135 where the Tax Court applied the analysis in Selfe to Eleventh Circuit residents and distinguished their facts from Selfe, but did find that Selfe was substantial authority and denied penalties for substantial understatement on the Wise’s deficiency pertaining to the disallowed S corporation losses; see also Russell v. Commissioner, T.C. Memo 1990-217; Suisman v. Commissioner, T.C. Memo 1989-629.

reason that the shareholder did not make a direct loan to the corporation, but rather has provided a form of guarantee for the third-party lender.\footnote{See Duke v. Commissioner, T.C. Memo 1976-50; Bader v. Commissioner, T.C. Memo 1987-30; Nigh v. Commissioner, T.C. Memo 1990-349; Harrington v. United States, 605 F. Supp. 53 (D. Del. 1985).} Similarly, the courts have also denied loss limitation basis to shareholders providing personal assets as security for S corporation debt.\footnote{See Calcutt v. Commissioner, 84 T.C. 716 (1985); Blum v. Commissioner, 59 T.C. 436 (1972), modified by 32 T.C.M. 158 (1973); Williams v. Commissioner, T.C. Memo 1981-54; Albert v. Commissioner, T.C. Memo 1980-567.} In each of the foregoing tax matters, the courts or the Service analogized the substance of the shareholder debt structures to a shareholder guarantee resulting in the absolute denial of basis for these S corporation shareholders. In short, the courts and Service are quick to recharacterize shareholder debt structures as shareholder guarantees, because the black letter law denial of loss basis for shareholder guarantees is so sound.

In Underwood v. Commissioner,\footnote{See Duke v. Commissioner, T.C. Memo 1976-50; Bader v. Commissioner, T.C. Memo 1987-30; Nigh v. Commissioner, T.C. Memo 1990-349; Harrington v. United States, 605 F. Supp. 53 (D. Del. 1985).} the Fifth Circuit Court of Appeals and the Tax Court reasoned that a shareholder’s debt restructuring among controlled corporations merely created a shareholder guarantee that would only give rise to shareholder basis if and when the shareholder made a payment on his indebtedness to his S corporation. The shareholder owned all of the stock of two corporations. When it became apparent that the shareholder did not have sufficient basis for his projected S corporation pass-through net operating losses, he restructured the obligations between his two corporations. First, the lender corporation surrendered the notes executed by the borrowing corporation marking them “paid.” Second, the borrowing corporation issued a demand promissory note to the shareholder; and, third, the shareholder executed a demand note to the lender corporation for the full amount of the original indebtedness.

As a result, the borrowing S corporation was indebted to the shareholder and the shareholder was indebted to the lending corporation. The Tax Court and the Fifth Circuit found
that under the Internal Revenue Code of 1986, as amended, these transactions did not create indebtedness from the S corporation to the shareholders. Because the shareholder had not paid out any funds, and would not until his note came due, the courts characterized the structure as indistinguishable from a guaranty. As a result of this characterization, the Tax Court and the Fifth Circuit denied the shareholder basis for pass-through net operating losses.

A more factually accurate analysis would be that the courts determined that the restructuring of the indebtedness did not result in “true indebtedness” running from the S corporation to the shareholders. The courts believed that because the S corporation’s indebtedness to its shareholders was related party debt, it lacked any substance. The courts stretched to find an analogy to a guarantee rather than work through a cumbersome “sham transaction, lack of economic substance” analysis. After analogizing the debt restructuring to a guarantee, the courts concluded that loss basis is not allowed for shareholder guarantees. As a result, the courts held the pass-through losses were disallowed due to inadequate loss basis.

The predilection of the courts to recharacterize shareholder debt structures as guarantees was illustrated recently by the Tax Court and the Seventh Circuit Court of Appeals in the case of Grojean v. Commissioner. Most interestingly, Justice Posner in the Seventh Circuit’s opinion discusses economic scholarship in the area of guarantees and finds no economic distinctions between a lender and a guarantor. This lack of any economic distinction illuminates the irrelevance of the courts’ recharacterization of the Grojeans’ debt structure as a guarantee.

36 535 F.2d 309 (5th Cir. 1976), aff’g 63 T.C. 468 (1975).
37 I.R.C. § 1366(d)(1).
38 Underwood, 63 T.C. at 475-476.
39 But see Culnen v. Commissioner, TC Memo 2000-139 (2000) rev’d on other grounds, 2002 U.S. App. LEXIS 238 (3d Cir. Jan. 7, 2002); see also Yates v. Commissioner, T.C. Memo 2001-280 (2001) (all transfers were made directly from one wholly-owned corporation to the other and recorded first as company to company loans and later as shareholder loans on the books and records).
However, the Seventh Circuit concludes that in practice there is a distinction between a lender and a guarantor and affirms the Tax Court’ recharacterization resulting in a disallowance of the Grojeans’ pass-through net operating losses.

**The Seventh Circuit and the Tax Court Recharacterize a Loan Participation Agreement as a Shareholder Guarantee and Deny Shareholder Basis**

Thomas and Theresa Grojean formed an S corporation for the sole purpose of acquiring a trucking company. American National Bank (“ANB”) agreed to finance the S corporation’s purchase of the trucking company, but insisted that the Grojeans’ personally guarantee the S corporation debt. The Grojeans were unwilling to undertake that risk and the parties negotiated an alternative structure.

The revised structure involved three loans from ANB. Two of the three loans were an $8.4 million loan and a $2.6 million revolving credit loan each payable to the S corporation. The third loan was a $1.2 million loan to the Grojeans, secured by the Grojeans shares of S corporation stock. In addition, the Grojeans and ANB entered into an agreement whereby the Grojeans agreed to purchase a $1.2 million participation interest in ANB’s $8.4 million loan to the S corporation. The Grojeans paid for their participation interest with the loan proceeds from ANB on their $1.2 million personal loan. The Grojeans’ ANB loan and the S corporation’s loan each had identical interest rates and were both 6-year notes due on September 1.

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40 78 T.C.M. 1249 (1999). In its “findings of fact” section, the Tax Court notes that Mr. Grojean graduated from the University of Notre Dame with a B.S. in accounting and worked for Price Waterhouse as a certified public accountant and a chief financial and operating officer for an all-cargo airline.

41 Shortly after this transaction, ANB and the Grojeans restructured the Grojeans’ note from ANB and the participation interest to include a $1,000,000 interest in the $8.4 million ANB note and a $200,000 interest in the $2.6 million revolving credit loan, keeping the total Grojean loan and participation interest at $1,200,000. The Grojeans’ loans ($1,000,000 loan and $200,000 revolving credit note) mirrored the terms of the corresponding loans to their S corporation.
The participation agreement provided that ANB’s interest in the S corporation note was superior to the Grojeans’ interest in the note. The Grojeans were entitled to monthly interest payments only upon payment of the interest by their S corporation to ANB and were not entitled to participate in any of the principal payments, until ANB had recovered its full share of principal. Moreover, ANB had sole authority and discretion to exercise its rights under its note to the S corporation without the advice or consent of the Grojeans.

Unfortunately, the Grojeans’ S corporation suffered net operating losses. These net operating losses were allocated to the Grojeans and were not limited because the Grojeans included their $1.2 million participation interest in their S corporation basis for loss limitation calculations. The Service denied this additional basis claiming that the participation was a disguised guaranty. The Tax Court analyzed the debt structure created by the Grojeans and ANB and determined that “[l]ike a guarantor, the Grojeans would not be liable – thus not called upon to make an economic outlay – unless its S corporation defaulted.”

The Grojeans argued that they had made back-to-back loans. Their position was that there was bona fide loan between themselves and ANB, and between them and their S corporation. However, the Tax Court found that the participation agreement made clear that the Grojeans had not made any bona fide loan to their S corporation. The court argued that there was no note or other contract between the Grojeans and their S corporation. Moreover, the court found that ANB had sole authority and discretion to enforce all rights under its notes to the S corporation, without the advice or consent of the Grojeans. If the S corporation failed to pay, the

42 The Service disallowed pass-through net operating losses of $1,186,375 for 1989; $9,389 for 1990; and $28,273 for 1991 and assessed tax deficiencies plus failure to file timely penalties of approximately $324,000 for all three tax years.
43 Id.
Grojeans had no direct contractual rights against their S corporation. In short, the Tax Court found that there was no “direct obligation” from the S corporation to the Grojeans.

Additionally, because the notes from the S corporation to ANB were the mirror image of the Grojeans notes to ANB, the court found that there was complete circularity of funds. The Grojeans would make an economic outlay to ANB only if their S corporation did not meet its ANB obligations. Therefore, the Grojeans status was in substance not that of their S corporation's creditor but of guarantors of the S corporation's debt to the bank.

To make matters worse for the Grojeans, the S corporation’s accountants characterized the Grojeans’ participation agreement as a guarantee on the S corporation’s financial statements. Moreover, the Grojeans’ own expert witness pronounced that the Grojeans would more or less have no rights against its S corporation with respect to the S corporation’s default on the ANB notes in a bankruptcy proceeding. As a result, the Grojeans back-to-back loan argument, which the Service and the courts have recognized as an effective vehicle for additional shareholder basis,44 failed.

Despite these glaring missteps in Tax Court and in their well-intentioned structure, the Grojeans’ zeal for loss basis was not quashed. The Grojeans appealed their case to the Seventh Circuit Court of Appeals.45 In his opinion, Justice Posner endeavors to understand the economic distinctions between a loan and a guaranty as follows:

“The difference between a loan and a guaranty may seem a fine one, since,

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44 The Tax Court blessed stock basis increases for direct shareholder loans to their S corporations where the shareholders had borrowed the loan proceeds from a third-party lender immediately before the shareholders loans to their S corporation. See Raynor v. Commissioner, 50 T.C. 762 (1968); see also Gilday v. Commissioner, T.C. Memo 1982-242 (1982) (S corporation shareholder substitution of personal notes to bank for S corporation note guaranteed by shareholders resulted in tax basis for obligated S corporation shareholders). Moreover, the courts in Underwood v. Commissioner, 535 F.2d 309 (5th Cir. 1976), aff’g 63 T.C. 468 (1975), could have found failed back-to-back loans rather than a guarantee.

45 Grojean v. Commissioner, 248 F.3d 572 (7th Cir. 2001).
when the amount is the same, the lender and guarantor assume the same risk.

The difference between the two transactional forms may seem to amount only to this: the loan supplies funds to the borrower, and the guaranty enables funds to be supplied to the borrower. That is indeed the main difference, but it is not trivial or nominal ("formal"). As explained in Avery Katz, "An Economic Analysis of the Guaranty Contract," 66 U. Chi. L. Rev. 47, 113-14 (1999), the three-cornered arrangement (borrower, lender, guarantor) created by a guaranty makes economic sense only if the lender has a comparative advantage in liquidity (that is, in being able to come up with the money to lend the borrower) and the guarantor a comparative advantage in bearing risk. Otherwise the additional transaction costs of the more complex arrangement would be uneconomical. At a high enough level of abstraction, it is true, the difference between providing and enabling the provision of funding may disappear. Indeed, at that level, the difference between equity and debt, as methods of corporate financing, disappears. See Franco Modigliani & Merton H. Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment," 48 Am. Econ. Rev. 361 (1958).

After this somewhat esoteric economic analysis, the Seventh Circuit concludes that the substance of the Grojeans’ participation agreement is that of a guarantee.

In response, the Grojeans make an interesting but circular and unsuccessful argument that “[i]f the government can ignore the form of [their] ‘guaranty,’ reclassifying it from a loan participation to a guaranty on the basis of its economic substance, why shouldn’t the Grojeans be allowed to reclassify their loan participation interest as a loan by them to their S corporation, since there is no functional difference between the two characterizations.” The Seventh Circuit responds with “the doctrine of substance over form allows only the government to recharacterize a transaction.” However, Justice Posner, apparently not satisfied with the one-sidedness of this position, finds that once again the Grojeans own expert undermines their argument. The court noted that the Grojeans were trying to defeat the form of their participation agreement with the arguable substance that substance of their transaction was a loan to their S corporation.

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46 Id. at 573-574.
However, according to the Grojeans’ expert in any bankruptcy preceding the substance of the participation agreement would establish that the Grojeans were not a creditor of the S corporation and would escape the one-year extended preference period for insider creditors of a bankrupt firm.49

The Seventh Circuit concludes its opinion by stating “that the loan participation was in reality a guaranty.”50 Thus, the Seventh Circuit affirms the Tax Courts’ decision to disallow the Grojeans’ pass-through net operating losses due to inadequate shareholder stock and indebtedness basis.

**Lessons from the Grojeans**

S corporation shareholders desiring basis for pass-through net operating losses can learn valuable lessons from the Grojean cases. Specifically, all of the professionals representing the S corporation and/or the shareholders should be involved in planning any S corporation transaction to maximize all legal protections and benefits, including bankruptcy and tax matters. The Grojeans’ structure was designed to avoid problems in case of a bankruptcy (that is, that the Grojeans did not want to be characterized as insider creditors subject to the extended preference period), but this structure conflicted with their tax goals (that is, that the Grojeans wanted to be characterized as direct lenders to their S corporation). As a result of this conflict, the Grojeans’ own witness repeatedly undermined their position that they were direct lenders (through their back-to-back loan argument) in his courtroom testimony. The witness stated that in a bankruptcy preceding the Grojeans would not have any creditor rights. Moreover, the Grojeans’ own accountants had prepared financial statements for three consecutive years stating that the

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47 Id. at 576.
48 Id.
49 Id. at 577.
Grojeans’ participation interest was a $1.2 million guarantee of their S corporation’s ANB debt. When a taxpayers’ own professionals testify against them, courts are not compelled to disagree.51

The terms of the ANB note to the Grojeans’ S corporation and the Grojeans’ participation interest in the note did not provide the Grojeans with any legal rights against their S corporation typical in a creditor-debtor relationship. The Grojeans had no direct contract or note payable between them and their S corporation. ANB had complete control and discretion with respect to any decisions regarding the S corporation’s indebtedness. These facts undermined the Grojeans’ argument that they had made back-to-back loans. The loan from ANB to the Grojeans was evidenced with a promissory note and their alleged loan to their S corporation was evidenced by their participation agreement with ANB. However, neither the Tax Court nor the Seventh Circuit found any evidence of a direct obligation from the S corporation to the Grojeans.

If the Grojeans had engaged in properly documented back-to-back loans, they would have prevailed at the audit level or in Tax Court and never would have visited the Seventh Circuit.52 The Tax Court and the Service have allowed basis for properly documented back-to-

50 Id.
51 But see Culnen v. Commissioner, TC Memo 2000-139 (2000) rev’d on other grounds, 2002 U.S. App. LEXIS 238 (3d Cir. Jan. 7, 2002). In Culnen, the Tax Court seemed convinced by the taxpayer’s and his tax advisers’ testimony, the bookkeeping entries to loan payable general ledger accounts and the consistency of the presentation of the loans on financial statements and tax returns that Culnen was the lender rather than his S corporation. See also Yates v. Commissioner, T.C. Memo 2001-280 (2001). In Yates, the Tax Court was convinced by Mr. Yates’ “uncontradicted and credible testimony” that the relevant transfers gave rise to S corporation stock basis. Moreover, in each of the foregoing cases, the Tax Court criticized the government for raising “moot, irrelevant, or meritless” arguments or for “unsupported, unpersuasive and offensive attacks on the credibility of Culnen and the ethics of his witnesses.” The Tax Court in Culnen strongly admonished the government for relying on the tactic of trial by cross-examination and its resort to unacceptable name-calling as a fallback position.
back loans even when there is complete and immediate circularity of cash. However, under the back-to-back loan structure the Grojeans would be subject to the more onerous “insider creditor preference rules” they were trying to avoid. The Grojeans and their professionals had to decide which goals were more critical. Apparently, in the planning stages the choice for bankruptcy protection overrode the demand for potential tax benefits. Given the Grojeans determined and likely expensive fight for the tax benefits through their audit, Tax Court and the Seventh Circuit, one wonders if they made the right choice or if they even had tax counsel during their debt structure planning stage. However, Mr. Grojean was a sophisticated and experienced businessman who had worked for Price Waterhouse as a certified public accountant. Therefore, the Grojeans should have understood the potential consequences of their debt structure. The Grojeans may have made an informed decision to structure their debt in a manner to minimize their perceived greatest potential risk of bankruptcy. Inopportune, the debt structure that minimized their bankruptcy risks did not maximize their tax benefits by increasing their basis for pass-through net operating losses.

**Conclusion**

Regrettably, perhaps as a result of the Grojeans’ failure to properly structure, document and argue back-to-back loans, this sophisticated and well-reasoned appellate court opinion will lend more weight to the already existing heavy weight of authorities for recharacterizing S corporation shareholder debt structures as guarantees. Taxpayers can hope that the Seventh Circuit may have provided an intellectual thread to the economic argument that the substance of any differences between a lender and a guarantor are economically meaningless and, therefore, any recharacterization is unjustifiable. The Seventh Circuit responded to this high-level

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53 *Id.*
economic argument by stating, “at the operational level, because of various frictions that some economic models disregard, such as transaction and liquidity costs, there really is a substantive and not merely a formal difference between lending and guaranteeing.”

Accordingly, S corporation shareholders desiring debt basis for their S corporation loans must scrutinize their debt structures and supporting documentation to ensure that they are direct lenders to their S corporations and cannot be recharacterized for any reason as guarantors.

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54 Id. at 574.