Estate of Leavitt v. Commissioner, 90 T. C. 206 (1988)

A shareholder's guarantee of an S corporation's debt does not increase the shareholder's basis in the corporation's stock without an economic outlay.

Summary

In Estate of Leavitt v. Commissioner, shareholders of an S corporation, VAFLA Corp. , guaranteed a loan to the corporation from a bank. The corporation was insolvent at the time of the loan, which was approved solely due to the guarantors' financial strength. The shareholders argued that their guarantees should increase their stock basis to allow deductions for their share of the corporation's losses. The Tax Court held that without an economic outlay by the shareholders, the guarantees did not increase their basis. This decision reinforced the principle that shareholders must actually pay on a guarantee before it can increase their basis in S corporation stock.

Facts

VAFLA Corp. , an S corporation, was formed to operate an amusement park. It incurred significant losses from inception. Shareholders, including Daniel Leavitt and Anthony D. Cuzzocrea, guaranteed a $300,000 loan from the Bank of Virginia to VAFLA. At the time of the loan, VAFLA's liabilities exceeded its assets, and it could not meet its cash-flow needs. The loan was approved only because of the guarantors' financial strength. VAFLA made all loan payments, and no payments were made by the guarantors.

Procedural History

The Commissioner of Internal Revenue disallowed loss deductions claimed by the shareholders beyond their initial $10,000 investment. The shareholders petitioned the Tax Court, arguing that their guarantees increased their basis in VAFLA's stock, allowing greater loss deductions. The Tax Court consolidated related cases and ruled against the shareholders, affirming the Commissioner's position.

Issue(s)

1. Whether a shareholder's guarantee of an S corporation's debt increases the shareholder's basis in the corporation's stock without an economic outlay?

Holding

1. No, because without an economic outlay, such as payment on the guarantee, the shareholders' basis in their stock cannot be increased.

Court's Reasoning

The Tax Court emphasized that for a shareholder's basis in S corporation stock to increase, there must be an economic outlay or realization of income by the shareholder. The court cited previous cases like Brown v. Commissioner and Calcutt v. Commissioner to support this requirement. The court rejected the shareholders' argument that the loan should be viewed as made to them and then contributed as capital to VAFLA, as this would allow shareholders to skirt the basis limitation Congress intended. The court also distinguished the case from Selfe v. United States, where a different circuit applied debt-equity principles to treat a guarantee as a capital contribution, stating that such an approach does not apply to S corporations without an economic outlay. The court noted the dissent's argument for applying debt-equity principles but maintained that without payment by the shareholders, no basis increase was justified.

Practical Implications

This decision impacts how S corporation shareholders can claim loss deductions by clarifying that guarantees alone do not increase basis. Practitioners must advise clients that guarantees must be paid upon to increase basis, affecting planning for loss deductions. This ruling may deter shareholders from relying solely on guarantees to increase their basis, potentially affecting their willingness to guarantee corporate debts. The case also highlights the differences between S and C corporations regarding the treatment of shareholder guarantees, reinforcing the need for careful tax planning in S corporation structures. Subsequent cases have continued to follow this principle, though some have explored alternative theories for increasing basis, such as direct loans from shareholders to the corporation.

