STATE OF ALABAMA, DEPARTMENT OF REVENUE, vs. JOE D. & LINDA ACKER Route. 2, Box 176-5 Fayette, AL 35555, Taxpayers.	§ § § § § §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION DOCKET NO. INC. 92-227

FINAL ORDER

The Revenue Department assessed income tax against Joe D. & Linda Acker for the years 1988 and 1990. The Ackers appealed to the Administrative Law Division and a hearing was conducted on October 20, 1992. Jim Grant, Jr. and Hank Hutchinson appeared for the Ackers. Assistant Counsel Dan Schmaeling represented the Department. The facts are undisputed.

A. D. Management, Inc. (corporation) was formed by the Joe D. Acker (Taxpayer) in January, 1988 and is in the cable television business in Fayette, Alabama. The corporation has at all times elected to be treated as an S corporation for both federal and Alabama income tax purposes.

Citizens Bank of Fayette issued numerous loans totaling $1,074,000.00 to the corporation as debtor from 1988 through 1990. The loans were all signed twice by the Taxpayer, once as vice-president of the corporation and again personally. The loan proceeds were used solely by the corporation for business purposes.

The corporation had no balance sheet net worth during the

subject years. Consequently, the bank required the Taxpayer to personally secure the loans by pledging certificates of deposit and money market funds he had on deposit at the bank. The bank president testified that the bank looked to the Taxpayer for payment and that the bank agreed to make the loans only because they were personally guaranteed by the Taxpayer.

The corporation listed the loans as loans from the bank on its books, and the periodic interest payments were made by the corporation. The Taxpayer was not required to make any principal or interest payments on the loans during the audit period.

The corporation also borrowed $3,500,000.00 from AmSouth Bank in December 1988. The corporation pledged all of its assets as collateral for the AmSouth loan and was prohibited by the loan agreement from pledging the assets as security for any other loan. The Taxpayer signed the AmSouth loan personally as guarantor.[1]

The corporation suffered losses in 1988 and 1990 and the Taxpayers attempted to pass-through the losses to their individual Alabama returns for those years. However, an S corporation shareholder cannot claim a pass-through loss in excess of his basis in the corporation or the amount of debt owed by the corporation to

[1] The Taxpayer does not argue that his basis should be increased by the amount of the AmSouth loan.

the shareholder. See, Code of Ala. 1975, §40-18-162(d) and related federal statute 26 U.S.C.A. §1366(d). Consequently, the Department denied the pass-through losses in both years because they exceeded the Taxpayer's basis in the corporation.

The Taxpayer argues that his basis should be increased by the amount of the Citizen Bank loans because the loans were in substance to him and not to the corporation.

The general rule is that a loan guarantee by an S corporation shareholder cannot by itself increase the shareholder's basis in the corporation, even if the creditor looks primarily to the shareholder for repayment. See, Brown v. Commissioner, 706 F.2d 755 (6th Cir. 1983); Estate of Leavitt v. Commissioner, 875 F.2d 420 (4th Cir. 1988); Harris v. U.S., 902 F.2d 439 (5th Cir. 1990); Underwood v. Commissioner, 535 F.2d 309 (5th Cir. 1976), and the numerous cases cited therein. Rather, there must first be some economic outlay by the shareholder. Also, a taxpayer is bound by the form he chooses for a transaction and cannot later argue that the substance of the transaction is different than the form for tax purposes.

The Taxpayer acknowledges the general rules set out above, but argues that the Eleventh Circuit's decision in Selfe v. U.S., 778 F.2d 769 (1985) is controlling. The Selfe court also recognized the general rules set out above,[2] but held that a shareholder's

[2] Selfe concedes that an economic outlay is necessary, but

basis may be increased "where the facts demonstrate that, in substance, the shareholder has borrowed funds and subsequently advanced them to (the) corporation". See Selfe, at page 773. The Eleventh Circuit then remanded the case to the district court for a determination of that fact issue.

I agree with the Department that Estate of Leavitt, Brown and the other cases cited by the Department represent the majority view and should be followed, notwithstanding that Selfe is an Eleventh Circuit case. Where an Alabama tax statute is modeled after a federal statute, the prevailing federal authority should be followed in construing the Alabama statute. Best v. Dept. of Revenue, 417 So.2d 197 (1981). However, even the cases relied on by the Department agree with Selfe to the extent that an increased basis can be allowed if the evidence shows that the loan was in fact to the shareholder and not the corporation. As stated in Estate of Leavitt, at page 427: "Furthermore, to the extent that the Selfe court remanded because material facts existed by which the taxpayer could show that the bank actually lent the money to her rather than the corporation, we are still able to agree."

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that the mere pledging of stock as security was in itself an economic outlay. See, Selfe, footnote 7 at page 772.

Consequently, an increased basis can be allowed in this case if the bank loans were in fact to the Taxpayer personally and not to the corporation. Unfortunately for the Taxpayer, that was not the case.

The loans were issued in the name of the corporation. The loan proceeds were paid directly to and used solely by the corporation. The loans were listed as loans from the bank on the corporation's books, and importantly, periodic interest on the loans was paid by the corporation and not the Taxpayer. Also, there is no evidence that the Taxpayers treated the loans as personal loans on their individual income tax returns by reporting the interest payments by the corporation as constructive dividend income. See, Harris, at page 444. Finally, there was no economic outlay by the Taxpayer. In summary, the transactions were in substance and form loans to the corporation and not to the Taxpayer, and consequently no increased basis can be allowed.

The above result is not changed by the fact that the loans were issued solely on the creditworthiness of the Taxpayer or that the bank looked primarily to the Taxpayer for payment. Nor is it relevant that the Taxpayer signed as co-borrower and not as guarantor. As stated in Raynor v. Comm., 50 T.C. 762, 770-71 (1968), as cited in Estate of Leavitt, at page 423: "No form of indirect borrowing, be it guaranty, surety, accommodation, co-making or otherwise, gives rise to indebtedness from the

corporation to the shareholders until and unless the shareholders pay part or all of the obligation."

The Taxpayer could have easily structured the transactions so that the loans were first to him and then from him to the corporation, in which case an increased basis could be allowed. He did not and must now abide by the form chosen.

The article submitted by the Taxpayers, "Shareholder Guarantees of S Corporation Debt: Why Not Increase Basis?", Volume 4, Number 1, Journal of S Corporation Taxation, presents a good argument why in theory an increased basis should be allowed where a shareholder guarantees a loan to an S corporation. However, as discussed, the article is contrary to prevailing federal case law. This holding is also consistent with the rule that a deduction must be strictly construed against the taxpayer and for the taxing authority. Ex Parte Kimberly-Clark Corp., 503 So.2d 304.

The assessments in issue are affirmed. Judgment is entered for the Department and against the Taxpayers in the amount of $27,217.30 for 1988 income tax and $4,937.85 for 1990 income tax. Additional interest is due on the above amounts from April 22, 1992.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Alabama 1975, §40-2A-9(g).

Entered on January 25, 1993.

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BILL THOMPSON
Chief Administrative Law Judge