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BOARD OF EQUALIZATION
STATE OF CALIFORNIA

In the Matter of the Appeal of:

) **HEARING SUMMARY²**
) **PERSONAL INCOME TAX APPEAL**
)
) Case No. 522166

THOMAS NAJARIAN AND
TAMAR NAJARIAN¹

<u>Years</u>	<u>Proposed Assessments</u>
2003	\$24,217
2004	\$15,575
2005	\$17,917
2006	\$13,719

Representing the Parties:

For Appellant: Thomas and Tamar Najarian
For Franchise Tax Board: Sonia Deshmukh, Tax Counsel

QUESTION: Whether the Franchise Tax Board (respondent) correctly disallowed claimed loss deductions for tax years 2003, 2004, 2005, and 2006 because appellant Thomas Najarian lacked sufficient basis in the stock and debt of Thomas International Home Furnishings

¹ Appellants reside in Torrance, Los Angeles County.

² This appeal was postponed from the March 22, 2011, hearing calendar and rescheduled to the June 21, 2011, hearing calendar to allow appellants and their representative additional time to prepare for oral hearing.

1 (TIHF), an S corporation.

2 HEARING SUMMARY

3 Factual Background

4 During tax years 2003 through 2006, Mr. Najarian was a 100 percent shareholder in
5 TIHF, a California subchapter S corporation, which was incorporated on March 15, 1995. (Resp.
6 Opening Br., p. 1, fn. 2, exhibit J.) Mr. Najarian apparently made an initial capital contribution of
7 \$100,000 resulting in an initial stock basis of \$100,000. (*Id.*, p. 1, fn. 3, exhibit A.) For tax years 2003
8 through 2006, TIHF reported on its California tax returns net losses of \$240,577 for tax year 2003,
9 \$144,288 for tax year 2004, \$168,322 for tax year 2005, and \$139,348 for tax year 2006. (*Id.*, exhibits
10 B-E.) Appellants filed joint income tax returns for tax years 2003 through 2006 on which they claimed
11 loss deductions from flow-through ordinary losses from TIHF for the respective above-mentioned
12 amounts, which reduced appellants' personal income tax liabilities accordingly. (Resp. Opening Br.,
13 p. 2, fn. 8, exhibits F-I.)

14 In three audit letters dated April 9, 2007, respondent informed Mr. Najarian that it
15 reviewed his returns for tax years 2003, 2004, and 2005, and was fully disallowing the claimed flow-
16 through losses from TIHF for each of these tax years. (Resp. Opening Br., p. 2, exhibit J.) These letters
17 state that if Mr. Najarian believes he has enough basis to take the flow-through loss deduction claimed
18 on his returns, he should produce a basis schedule (including stock and debt basis in the corporation) for
19 the period starting from Mr. Najarian's initial contribution and ending on December 31 of each tax year
20 at issue and documentation, such as copies of cancelled checks, showing his capital contributions and
21 any loans mentioned in the basis schedule. (*Ibid.*) Mr. Najarian's representative subsequently provided
22 respondent with copies of the 2000 through 2005 Schedules of Shareholder's Basis Computation. (*Id.*,
23 p. 2, exhibit A.)³ In addition, Mr. Najarian's representative provided respondent with copies of a line of
24 credit agreement dated September 19, 2000 (first line of credit agreement) and a promissory note dated
25 September 19, 2000 (first promissory note), both of which reflect a loan in the amount of \$1,787,000
26 from Antoine Assadourian (lender) to TIHF (borrower). (*Id.*, exhibit K.) Mr. Najarian executed the
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28 ³ Staff notes that respondent asserts that Schedules of Shareholder's Basis Computation for tax years 2003 through 2006 were produced, but there was no such schedule for tax year 2006 included in the file.

1 First Promissory Note as both the president and secretary of TIHF. (*Ibid.*)

2 In a letter dated August 21, 2007, respondent asked Mr. Najarian to review the enclosed
3 Audit Issue Presentation Sheet concerning tax years 2003, 2004, and 2005 and to respond in writing no
4 later than September 10, 2007. (Resp. Opening Br., pp. 2-3, exhibit L.) In the Audit Issue Presentation
5 Sheet, the auditor determined that the loan between a third party lender and TIHF did not increase Mr.
6 Najarian's debt basis, there were inaccuracies associated with the provided Schedules of Shareholder's
7 Basis Computation, and Mr. Najarian did not have any stock or debt basis in TIHF as of tax year 2003.
8 The auditor recommended the disallowance of the pass-through losses in tax years 2003, 2004, and
9 2005, which create additional tax due of \$24,216, \$15,636, and \$17,983, respectively. (*Ibid.*) The
10 auditor also "recommend[ed] that Mr. Najarian begin the 2006 tax year with a zero beginning stock
11 basis in Thomas International Home Furnishings along with a zero debt basis and limit any subsequent
12 flow-through losses accordingly." (*Ibid.*)

13 On January 16, 2008, respondent issued Notices of Proposed Assessment (NPAs) for tax
14 years 2003, 2004, 2005, and 2006, which disallow losses from the S Corporation in the amounts of
15 \$240,577, \$144,288, \$168,322, and \$142,975, respectively. (Resp. Opening Br., p. 3, exhibit M.) The
16 NPAs also adjust appellants' exemption credits and revise their California itemized deductions to the
17 maximum amount allowable for their filing status. (*Ibid.*) The NPAs propose additional tax in the
18 amounts of \$24,217, \$15,575, \$17,917, and \$13,719 for tax years 2003, 2004, 2005, and 2006,
19 respectively. (*Ibid.*) Appellants timely protested the NPAs. (*Id.*, p. 3.)

20 At the June 15, 2009 protest hearing, Mr. Najarian's representative stated that he believed
21 that Mr. Najarian made payments on the promissory note during the tax years at issue and he would
22 have Mr. Najarian search his records to find evidence of these payments. (Resp. Opening Br., pp. 3-4,
23 exhibit N.) In a letter dated November 6, 2009, the hearing officer stated that she did not receive any
24 such documentation and she recommended affirming the audit adjustments. (*Ibid.*) On December 28,
25 2009, respondent issued Notices of Action (NOAs) for tax years 2003, 2004, 2005, and 2006 affirming
26 the NPAs. (*Id.*, p. 4, exhibit O; Appeal Letter, Attachments.) Appellants filed this timely appeal.

27 Procedural Background

28 In a letter dated February 3, 2010, the Board accepted appellants' letter dated January 15,

1 2010, as an Appeal Letter and requested a brief from respondent by no later than May 4, 2010. In a
2 memorandum dated April 6, 2010, respondent requested that this appeal be placed in “appellant open
3 status” because the Appeal Letter does not meet the requirements of California Code of Regulations,
4 title 18, chapter 4, section (Regulation) 5420. Specifically, respondent asserts that the Appeal Letter
5 lacks sufficient substantive facts, legal arguments, and legal authorities for respondent to submit an
6 opening brief. In a letter dated April 13, 2010, the Board informed respondent that it was denying its
7 request and respondent still had until May 4, 2010 to file its opening brief.

8 In a memorandum dated April 20, 2010, respondent again requested that this appeal be
9 placed in “appellant open status” because the Appeal Letter does not meet the requirements of
10 Regulation 5420. In the April 20, 2010 memorandum, respondent stated that the Appeal Letter contains
11 only a few conclusory statements regarding loans and appellants’ corporation and appellants’ legal
12 position is unclear. In a letter dated April 23, 2010, the Board informed appellants that they did not
13 provide enough substantive facts and documentation to support their position in this appeal and their
14 legal position is unclear. The April 23, 2010 letter requests appellants to identify which of the following
15 arguments they would like to address and why: 1) appellants loaned funds to the corporation and by
16 loaning funds to the corporation they increased their basis in the corporation; 2) appellants personally
17 guaranteed a debt of the corporation, which created basis in the corporation; or 3) appellants obtained a
18 personal loan and contributed monies from that loan to the corporation, which created basis in the
19 corporation. In a letter dated July 18, 2010 (appellants’ opening brief), appellants provided
20 supplemental information concerning their contentions in this appeal, which is discussed below.

21 Appellants’ Contentions

22 Appellants contend that on September 19, 2000, they borrowed \$1,840,000, as evident by
23 the attached line of credit agreement dated September 19, 2000 (second line of credit agreement) and
24 promissory note dated September 19, 2000 (second promissory note), both of which reflect a loan in the

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1 amount of \$1,840,000 from Mr. Assadourian, as lender, to Mr. Najarian, as borrower.⁴ (Apps. Opening
2 Br., Attachment.) They also contend that Mr. Najarian, as an individual, borrowed this sum from Mr.
3 Assadourian and then advanced the loan proceeds to TIHF. (*Ibid.*; Resp. Opening Br., exhibit R.)
4 Appellants further contend that the funds Mr. Najarian borrowed from Mr. Assadourian constitute loans
5 from the stockholders to TIHF and the loan advances to TIHF increased Mr. Najarian's basis, which
6 would permit appellants to deduct their losses for the tax years at issue. (Apps. Opening Br.) Lastly,
7 appellants state, "Therefore, the stockholder Mr. Thomas Najarian obtained a personal loan and
8 contributed monies from that loan to the corporation which created basis in the corporation." (*Ibid.*)

9 Respondent's Contentions

10 Respondent argues that it properly denied the claimed loss deductions for the tax years at
11 issue. According to respondent, the claimed loss deductions should be disallowed because appellants
12 failed to establish that Mr. Najarian's basis in indebtedness to TIHF should be increased for any tax
13 year. (Resp. Opening Br., p. 5.) Respondent contends that the documents appellants submitted in this
14 appeal do not prove that Mr. Najarian contributed or loaned money to TIHF or made payments on its
15 debt. (*Ibid.*) Respondent also contends that there is no evidence establishing that Mr. Najarian made an
16 economic outlay in the purported loan transaction, such as proof of payment of the obligation, which
17 generated a sufficient basis in indebtedness to allow the claimed loss deductions in any of the tax years
18 at issue. (*Id.*, pp. 5, 7.) In addition, respondent points out that neither of the promissory notes requires
19 any payment of principal or interest until December 1, 2007, upon written notice from the lender
20 requiring full payment of the loan, and in the absence of such written notice, no payment was due until
21 January 1, 2008. (*Id.*, pp. 9-10.) Respondent further points out that neither of the promissory notes
22 refers to any collateral or other security, which indicates that Mr. Najarian made no economic outlay in
23 the purported loan transaction. Citing *Estate of Leavitt v. Commissioner* (4th Cir. 1989) 875 F.2d 420,
24 *cert. denied* (1989) 493 U.S. 958, respondent argues, "If Appellant made no economic outlay in the loan
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26 ⁴ As discussed above, during the audit, appellants' representative submitted a line of credit agreement and a promissory
27 note, both of which are dated September 19, 2000, and which reflect a loan in the amount of \$1,787,000 from Antoine
28 Assadourian (lender) to TIHF (borrower). Staff refers to those documents as the first line of credit agreement and the first
promissory note. In their opening brief, appellants discuss and attach documents which staff describes here as the second
line of credit agreement and the second promissory note, as such documents are also dated September 19, 2000, and reflect
a loan from Mr. Assadourian.

1 transaction, no further analysis is needed and his claim of increased basis should be denied.” (*Id.*, p. 10.)

2 Moreover, respondent asserts that appellants have not disclosed whether any of the
3 purported shareholder debt has been repaid and there is no separate accounting for shareholder debt
4 reflected in TIHF’s returns, which makes it “impossible to track the income that will arise when
5 repayment of the reduced basis debt occurs.” (Resp. Opening Br., p. 9.) Citing *Smith v. Commissioner*
6 (1967) 48 T.C. 872, 879, respondent asserts that appellants are required to recognize as income a portion
7 of the repayment of indebtedness by TIHF. (*Ibid.*) Respondent also asserts that if TIHF made payments
8 on a shareholder loan to a third party lender, then appellants should have reported a constructive
9 distribution. (*Ibid.*)

10 Respondent further contends that, although appellants submitted with their opening brief
11 a copy of a second promissory note dated September 19, 2000, which indicates Mr. Najarian personally
12 borrowed \$1,840,000 from Mr. Assadourian, whereas the first promissory note dated September 19,
13 2000, indicates that TIHF borrowed \$1,787,000 from Mr. Assadourian, appellants have failed to produce
14 loan documents reflecting a subsequent loan between Mr. Najarian and TIHF. (Resp. Opening Br.,
15 p. 4.) Respondent asserts that appellants have failed to produce additional documentation establishing a
16 contribution of the loaned funds to TIHF. (*Ibid.*) Respondent further asserts that, other than the name of
17 the borrower and the amount of the loan, the two promissory notes appear to contain the following
18 identical terms: 1) no payment of principal or interest are required until December 1, 2007; 2) on
19 December 1, 2007, the Lender may deliver written notice to the Borrower requiring full repayment of
20 the loan; 3) absent such written notice demanding repayment, the monthly payment of principal and
21 interest is required beginning January 1, 2008; and 4) a subordination agreement provides that the
22 Lender agrees to subordinate his interest to the interest of Cedars Bank and incorporates by reference a
23 copy of the subordination agreement, although appellants did not provide respondent with a copy of the
24 subordination agreement. (*Id.*, pp. 4-5.) Citing *Raynor v. Commissioner* (1968) 50 T.C. 762, 771,
25 respondent contends that Mr. Najarian lacks sufficient debt basis to be entitled to the claimed loss
26 deductions because his purported loan to TIHF is not directly traceable to any actual contributions from
27 him. (Resp. Opening Br., p. 8.) Respondent argues that it is not clear which promissory note accurately
28 reflects the terms of any purported loan involving Messrs. Assadourian and Najarian and TIHF. (*Ibid.*)

1 Respondent contends that Mr. Najarian was not a party to the first promissory note and thus was not
2 liable for the purported loan and did not make a shareholder loan giving rise to debt basis. (*Ibid.*)
3 Assuming Mr. Najarian is the party who borrowed money from Mr. Assadourian, as reflected in the
4 second promissory note, respondent asserts that there is no evidence showing Mr. Najarian actually re-
5 loaned any funds to TIHF and appellants failed to produce a debt instrument reflecting a subsequent loan
6 of the borrowed funds to TIHF. (*Ibid.*) Respondent argues that any purported loan Mr. Najarian made
7 to TIHF in 2000 should have been reported as a shareholder loan on its balance sheet, but the balance
8 sheet attached to TIHF's 2000 California income tax return does not reflect any shareholder loans. (*Id.*,
9 exhibit S, p. 4.) Respondent further argues that appellants did not produce any other documentation,
10 such as bank deposit slips or bank statements, supporting their contention that Mr. Najarian contributed
11 loaned funds to TIHF. (*Id.*, p. 8.)

12 Respondent contends that the loans to TIHF reflected on the submitted Basis
13 Computation Schedules for tax years 2001, 2002, 2003, and 2004 in the amounts of \$186,161, \$1,487,
14 \$12,842, and \$11,023, respectively, do not appear in TIHF's California income tax returns for these tax
15 years and there is no separate accounting for total shareholder loans for these tax years. (Resp. Opening
16 Br., p. 8, fn. 43.) Respondent also argues that, assuming the submitted Basis Computation Schedules
17 accurately reflect Mr. Najarian's purported loans to TIHF that gave rise to the debt basis, the claimed
18 loss deductions for tax years 2003 through 2006 still exceed Mr. Najarian's stock basis and debt basis.
19 (*Ibid.*)

20 Respondent asserts that Schedule L (Balance Sheet) of TIHF's California income tax
21 returns for tax years 1999 through 2006 reflect approximately \$2,000,000 of outstanding "mortgages,
22 notes, bonds, payable in one year or more," which suggests the debt listed on TIHF's books is corporate
23 debt, most likely from the time of TIHF's inception, owed to a third party. (Resp. Opening Br., pp. 8-9.)
24 Respondent points out that the first paragraph of the first and second Line of Credit Agreements provide,
25 "Subject to the limitation set forth below, Lender has agreed to lend to Borrower funds from time to
26 time as Borrower may request in writing by way of Lines of Credit established in June 1995 and in
27 December 1997 between the parties." (*Id.*, p. 9, exhibits K, R.) According to respondent, in light of the
28 fact that TIHF was incorporated in 1995, the timing of the loan implies that the debt is corporate debt

1 extended directly from Mr. Assadourian to TIHF, which did not cost Mr. Najarian anything. (*Id.*, p. 9.)

2 Respondent argues that a shareholder's basis in debt loaned to an S corporation can
3 fluctuate in a manner similar to a stock basis and it can increase when the shareholder loans additional
4 funds to the S corporation or when there is a restoration of basis pursuant to Internal Revenue Code
5 (IRC) section 1367(b)(2)(B). (Resp. Opening Br., p. 7.) For these reasons, respondent asserts that "an S
6 corporation shareholder's debt basis must be tracked separately and perpetually in order to determine the
7 tax implications of debt repayment and the shareholder's ability to claim losses." (*Ibid.*) Respondent
8 contends that the submitted Schedules of Basis Computations demonstrate that Mr. Najarian neglected
9 to account accurately for adjustments to stock basis or debt basis. (*Id.*, exhibit A.)

10 Respondent contends that the two promissory notes are contradictory and do not support
11 a debt basis entitling appellants to the claimed loss deductions for the tax years at issue. (Resp. Opening
12 Br., p. 10.) Respondent points out that the first promissory note, which was produced during the audit
13 and protest proceedings in support of appellants' contention that Mr. Najarian should be entitled to
14 increase his debt basis in TIHF, cannot support such a contention because Mr. Najarian was not a party
15 to the first promissory note. (*Ibid.*) Citing *Harris v. United States* (5th Cir. 1990) 902 F.2d 439, and
16 *Estate of Leavitt v. Commissioner, supra*, respondent contends that, under the terms of the first
17 promissory note, appellant made no economic outlay and thus could not increase his debt basis, even if
18 he personally guaranteed the loan.

19 Respondent contends that appellants produced the second promissory note "[o]nly after
20 being advised that he would have had to be personally liable for the note to increase his debt basis
21 during and after the audit and protest proceedings." (Resp. Opening Br., p. 10.) Respondent asserts that
22 appellants have not explained the discrepancies between the two promissory notes, why the second
23 promissory note was not produced until July 2010, and whether only one of these loan instruments is
24 accurate or both of them evidence the same loan transaction. (*Ibid.*) Citing *Harris v. United States*,
25 *supra*, 902 F.2d at 443, respondent states, "Appellant may not simply replace the First Promissory Note
26 with the Second Promissory Note in an attempt to 'recast' the transaction in hindsight as one that
27 garners a more favorable tax result." (*Id.*, pp. 10-11.) Respondent contends that if both promissory
28 notes accurately evidence the purported loan transaction, then Mr. Najarian, as a shareholder, essentially

1 guaranteed the corporate debt and is not entitled to increase his debt basis. (*Id.*, p. 11.) Respondent
2 asserts that, other than the two promissory notes and the inaccurate basis schedules, appellants have
3 failed to produce information or documentation regarding the loan that demonstrates an economic outlay
4 in the loan transaction. (*Ibid.*)

5 Law and Analysis

6 Respondent's determinations are presumed correct, and appellant bears the burden of
7 proving error. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Ismael R. Manriquez*, 79-SBE-
8 077, Apr. 10, 1979.)⁵ Deductions are a matter of legislative grace, and appellants bear the burden of
9 establishing entitlement to deductions claimed. (*Appeal of Robert R. Telles*, 86-SBE-061, Mar. 4, 1986.)
10 Respondent's determination that a particular deduction should be disallowed is presumed correct. (*Todd*
11 *v. McColgan*, *supra*; *Appeal of Gilbert W. Janke*, 80-SBE-059, May 21, 1980.)

12 Moreover, a presumption of correctness attends respondent's determinations as to issues
13 of fact and appellant has the burden of proving such determinations erroneous. (*Appeal of Oscar D. and*
14 *Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980.) This presumption is a rebuttable one and will support a
15 finding only in the absence of sufficient evidence to the contrary. (*Ibid.*) To successfully rebut
16 respondent's determination the taxpayer must present uncontradicted, credible, competent and relevant
17 evidence to the contrary. (*Ibid.*) When the taxpayer fails to support his assertions with such evidence,
18 respondent's determinations must be upheld. (*Ibid.*) It is also well-established that a taxpayer's failure
19 to introduce evidence that is within his control gives rise to the presumption that the evidence, if
20 provided, would be unfavorable to his position. (*Appeal of Don A. Cookston*, 83-SBE-048, Jan. 3,
21 1983.)

22 Under California law, the tax treatment of S corporations and their shareholders is
23 determined in accordance with Subchapter S of Chapter 1 of Subtitle A of the Internal Revenue Code
24 (IRC) with certain exceptions not pertinent to the instant appeal. (Rev. & Tax. Code, §§ 17087.5,
25 23800.) The shareholders are required to treat the S corporation's income and deductions as if "realized
26 directly from the source from which realized by the corporation, or incurred in the same manner as
27 incurred by the corporation." (Int. Rev. Code, § 1366(b).) The IRC places a limitation on the pass-

28 ⁵ Board of Equalization cases can generally be viewed on the Board's website (www.boe.ca.gov).

1 through loss deductions that a shareholder may take on his tax return. Specifically, IRC section
2 1366(d)(1) provides as follows:

3 The aggregate amount of losses and deductions taken into account by a shareholder . . .
4 for any taxable year shall not exceed the sum of (A) the adjusted basis of the
5 shareholder's stock in the S corporation⁶ . . . and (B) the shareholder's adjusted basis of
6 any indebtedness of the S corporation to the shareholder . . .

7 With respect to stock, the shareholder's basis in his stock begins with the initial price he
8 paid for the stock or with the initial capital contribution he made in return for the stock, although the
9 shareholder may later increase his stock basis with additional capital contributions. (See Int. Rev. Code,
10 § 1012(a); *Ellinger v. United States* (11th Cir. 2006) 470 F.3d 1325, 1329 fn. 3.) With respect to debt
11 incurred by a loan, the shareholder must establish that the loan created "indebtedness of the
12 S corporation to the shareholder." (Int. Rev. Code, § 1366(d)(1)(B).)

13 IRC section 1366(d)(2) provides for an indefinite carryover of disallowed losses and
14 deductions to succeeding tax years. IRC section 1367(a) provides, in general, that the stock basis of
15 each shareholder in an S corporation shall be increased by items of income and decreased by items of
16 loss and deduction that are passed-through to him under IRC section 1366(a)(1). IRC section 1367(b)(2)
17 provides the following special rules for adjustments to a shareholder's debt basis in an S corporation
18 after the stock basis has been depleted:

19 (A) Reduction of basis. If for any taxable year the amounts specified in subparagraphs
20 (B), (C), (D), and (E) of subsection (a)(2) [relating to losses, deductions, noncapital,
21 nondeductible expenses, and certain oil and gas depletion deductions] exceed the amount
22 which reduces the shareholder's basis to zero, such excess shall be applied to reduce (but
23 not below zero) the shareholder's basis in any indebtedness of the S corporation to the
24 shareholder.

25 (See also Treas. Reg., sections 1.1367-2(b)(1).) All adjustments to basis pursuant to IRC section 1367
26 are determined as of the close of the S corporation's taxable year. (Treas. Reg. § 1.1367-1(d)(1).)
27 Accordingly, the shareholder's debt basis is reduced by such losses in excess of the shareholder's stock
28 basis. If in subsequent taxable years, however, the S corporation generates income, then the earnings
29 will be applied to restore the reduced debt basis before the earnings are applied to replenish the

⁶ IRC section 1367(a) generally provides that a shareholder's basis in stock is increased by the pass-through of items and income and decreased by the pass-through of items of loss, deductions, expenses, and distributions of property.

1 shareholder's stock basis. (Int. Rev. Code, § 1367(b)(2)(B); Treas. Reg. § 1.1367-2(c)(1).)
2 A shareholder's debt basis may also increase when the shareholder loans additional funds to the
3 S corporation under IRC § 1012(a). Thus, a shareholder's debt basis may fluctuate for various reasons.

4 Under the economic-outlay doctrine, a shareholder must make an economic outlay in
5 order to increase his basis in S corporation debt or stock. (See *Harris v. United States*, *supra*, 902 F.2d
6 at 443; *Estate of Leavitt v. Commissioner*, *supra*, 875 F.2d at 422; *Brown v. Commissioner* (6th Cir.
7 1983) 706 F.2d 755, 756.) As stated in *Wilson v. Commissioner*, T.C. Memo 1991-544:

8 To qualify as an "indebtedness" under section 1366(d)(1)(B) court cases have generally
9 held that the indebtedness must have been acquired by the shareholders through an actual
10 economic outlay. The economic outlay required under section 1366(d)(1)(B) must leave
11 "the [taxpayers] poorer in a material sense." [Citations omitted.]

12 "In applying the 'economic outlay' doctrine, the appellate courts have been nearly
13 unanimous in concluding that when a shareholder guarantees a loan, the existence of the guarantee does
14 not by itself increase the indebtedness of the S corporation to the shareholder." (*Maloof v.*
15 *Commissioner* (6th Cir. 2006) 456 F.3d 645, 650.) Similarly, the courts have held that "a security
16 interest on a shareholder's property by itself does not establish an economic outlay." (*Ibid.*) However, a
17 transaction involving a shareholder's guarantee of a third-party loan may constitute an economic outlay
18 increasing the shareholder's stock basis under two specific sets of circumstances. Under the first set of
19 circumstances, the shareholder who has personally guaranteed the loan must actually make payments on
20 the loan pursuant to the guarantee. (*Estate of Leavitt v. Commissioner*, *supra*, 875 F.2d at 422; *Uri v.*
21 *Commissioner* (10th Cir. 1991) 949 F.2d 371, 373-374; *Brown v. Commissioner*, *supra*, 706 F.2d at 756-
22 757.) Courts following this view have reasoned that a shareholder makes no economic outlay unless he
23 or she has incurred some monetary cost. (*Estate of Leavitt v. Commissioner*, *supra*, 875 F.2d at 422.)
24 The second transaction is a loan made to the shareholder who subsequently advances the loan proceeds
25 to the S corporation and remains the primary obligor to the lender. (*Selfe v. United States* (11th Cir.
26 1985) 778 F.2d 769, 773.) If the lender looks to the shareholder as the primary obligor on the loan, then
27 the guarantee may be treated as an equity investment by the shareholder. (*Blum v. Commissioner* (1972)
28 59 T.C. 436, 440.) However, if the lender expects repayment from the S corporation, then the
shareholder has incurred no economic outlay. (*Ibid.*)

1 Courts have strictly construed this type of transaction and have consistently rejected
2 taxpayers' arguments that a loan made directly to the S corporation is substantially the same as a loan
3 made to the shareholder, which the shareholder then contributed to the corporation. In this regard,
4 courts have applied the principle that "taxpayers are liable for the tax consequences of the transaction
5 they actually execute and may not reap the benefit of recasting the transaction into another one
6 substantially different in economic effect that they might have made." (*Estate of Leavitt v.*
7 *Commissioner, supra*, 875 F.2d at 423. See also *Ellinger v. United States, supra*, 470 F.3d at 1333;
8 *Harris v. United States, supra*, 902 F.2d at 443; *Brown v. Commissioner, supra*, 706 F.2d at 756.)

9 If an S corporation has defaulted on its loan payments or is otherwise unable to repay a
10 loan and a shareholder makes those payments, those payments result in an increase in the shareholder's
11 basis in corporate indebtedness. (*Estate of Leavitt v. Commissioner, supra*, 875 F.2d at 422; *Raynor v*
12 *Commissioner, supra*, 50 T.C. at 770-771.) Further, a shareholder who pays the S corporation's debt
13 acquires debt basis on the theory that the shareholder has a right of indemnification or a right of
14 subrogation against the corporation. (*Putnam v. Commissioner* (1956) 352 U.S. 82, 85.)

15 Staff Comments

16 At the hearing, appellants should be prepared to explain in detail the factual and legal
17 basis for their claimed loss deductions for each of the tax years at issue. Appellants should be prepared
18 to discuss and reconcile the two promissory notes and two line of credit agreements they produced in
19 this appeal, which are essentially identical except for the identity of the borrower and the amount of the
20 loan. According to respondent, the second promissory note and the second line of credit agreement,
21 which lists Mr. Najarian, rather than TIHF, as the borrower is not supported by any additional
22 documents showing a contribution of loaned funds to TIHF and these documents were only produced
23 after respondent informed appellants that the first promissory note and first line of credit agreement do
24 not establish their entitlement to the claimed loss deductions. Appellants should also be prepared to
25 discuss respondent's contention that there are numerous discrepancies and errors in their stock and debt
26 basis reporting. Pursuant to Regulation 5523.6, if appellants are able to locate any additional evidence
27 supporting their appeal, such as copies of cancelled checks, bank deposit slips or bank statements
28 indicating payments on the promissory note, such documents should be submitted to the Board and

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respondent at least 14 days prior to the hearing date.⁷

It appears that respondent issued the 2006 NPA and NOA without issuing an audit letter to appellants concerning tax year 2006. In addition, as discussed in footnote 2, a 2006 Schedule of Shareholder's Basis Computation has not been provided by the parties or made a part of the record. Staff notes, however, that the Audit Issue Presentation Sheet recommended that Mr. Najarian should begin the 2006 tax year with a zero beginning stock basis and a zero debt basis in TIHF and limit any subsequent flow-through losses. Respondent should be prepared to discuss how it computed appellants' tax assessment for tax year 2006, why there are three audit letters dated April 9, 2007, in the file concerning tax years 2003, 2004, and 2005, which informed Mr. Najarian that it was fully disallowing the claimed flow-through losses from TIHF for each of these tax years, but no similar audit letter in the file for tax year 2006, and why the Audit Issue Presentation Sheet did not address appellants' tax year 2006 account from the outset. (Resp. Opening Br., p. 2, exhibits J, L.)

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⁷ Exhibits should be submitted to: Claudia Madrigal, Board Proceedings Division, Board of Equalization. P. O. Box 942879 MIC: 80, Sacramento, CA 94279-0080