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Cleaning up intercompany debt

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Intercompany loans can spell trouble. Practitioners should discourage them because they often need to be cleaned up to avoid being recharacterized unfavorably by the IRS. Intercompany loans are loans between related entities, either between brother-sister companies or between a parent and a subsidiary. Related entities can include those entities that are technically related, for example, under Sec. 267(b)[1] and Sec. 1563,[2] or related in a broader sense where there is some common ownership.

This article focuses on intercompany debt between brother-sister S corporations. Where only year-end work is performed for the client, the practitioner is often made aware of an intercompany loan only after the fact. In many cases, there is a lack of legal formality, i.e., no promissory notes, no interest charged, a mere journal entry, or simply a bank transfer. Unwinding the transactions can be complicated and problematic, especially where there is little or no likelihood of repayment. In addition, unwinding the intercompany loans through a bad debt deduction and correlative cancellation-of-debt income may not always rest on solid technical grounds.

Loans between related corporations may be recharacterized by the IRS as equity contributions by the lending corporation's shareholders to the corporation receiving the loan when the existence of a true debtor-creditor relationship cannot be established between the corporations and where the loans lack a business purpose. This can result in a loan being treated as a constructive dividend.

While recharacterization of an intercompany loan can be an issue for any related corporations, it often presents itself among S corporations and their shareholders, as a recent Tax Court case, *Estate of Fry*,[3] illustrates. In the case, the Tax Court held that purported loans between two commonly owned S corporations were instead constructive dividends to the sole shareholder of the S corporations and corresponding capital contributions to one of the corporations.

Unlike in most cases involving a dispute between the IRS and a taxpayer over the characterization of a purported loan transfer, this was a favorable result for the taxpayer. Treating the purported loans as constructive dividends and capital contributions, the taxpayer was able to increase his basis in the S corporation receiving the loan, which in turn allowed him to deduct millions of dollars in losses incurred by the S corporation in the year in question that the IRS had disallowed. Before focusing on *Estate of Fry*, however, some background may be helpful.

Intercompany loans and constructive dividends

Constructive dividends generally arise when a shareholder receives a benefit from a corporation and does not reimburse the corporation for the full value of the benefit received. Shareholders of related corporations, such as brother-sister corporations, may be unaware that the IRS may be able to recharacterize a loan between the corporations as equity and treat it as a constructive dividend to the shareholders from the corporation making the loan, followed by a capital contribution by the shareholders to the corporation receiving the loan. An intercompany loan can be recharacterized as equity when the shareholder or shareholders of the corporations are viewed as receiving the primary benefit from the loan, rather than the corporation that makes the loan. In general, the courts use a two-prong test to determine whether intercompany loans between commonly owned corporations are constructive dividends.[4]

In the first prong, the court determines whether the loan constitutes bona fide indebtedness. If it does, no constructive dividend occurs. If the loan is not bona fide indebtedness, the court examines whether it was made for the shareholder's benefit. In the second prong of the test, to avoid constructive dividend treatment, the shareholder must prove that there was a corporate business purpose for the loan that benefited the corporation making the loan rather than the common shareholder or shareholders of the corporations.

In *Wilkof*,[5] two brothers, Edward and Ervin Wilkof, each owned a 50% interest in Wilkof Structural Steel Corp. (WSS). Edward and Ervin each also owned a 50% interest in TWN Manufacturing Co. Inc. (TWM). TWM experienced financial difficulties and reported losses on its federal income tax returns. TWM was able to obtain outside bank financing from two banks. To assist TWM in repaying its bank

1. Relationships for purposes of losses, expenses, and interest with respect to transactions between related taxpayers.
2. Defines controlled group of corporations, including parent-subsidiary controlled groups and brother-sister controlled groups.
3. *Estate of Fry*, T.C. Memo. 2024-8.
4. See discussion of court cases that follow. While Treasury issued final regulations (T.D. 9790) in 2016 that seek to recharacterize certain covered debt instruments as equity between members of an expanded group in certain transactions, large domestic C corporations are the target of the regulations. The regulations do not apply to covered debt instruments issued by the expanded group if the aggregate adjusted issue price held by the members of the expanded group does not exceed $50 million. The regulations also do not apply to S corporations. See Burnett et al., "Sec. 385 Regulations Impose Intergroup Debt Requirements," 48 *The Tax Adviser* 62 (January 2017), and Sites and Perry, "Sec. 385 Regs.: Five Key Themes Every Company Needs to Know," 48 *The Tax Adviser* 79 (February 2017). The judicial tests continue to apply otherwise and are the focus here.
5. *Wilkof*, T.C. Memo. 1978-496, aff'd *per curiam*, 636 F.2d 1139 (6th Cir. 1981).

loans, WSS transferred $420,000 to TWM. The transfer of funds from WSS to TWM was not documented with a promissory note or any other written promise to pay. There was no fixed maturity date, no schedule for repaying principal or interest, and no interest rate. The Tax Court also noted that there was no sinking fund, no collateral, and no personal guarantees from the shareholders. The transfer was recorded in the corporate books as an asset to WSS and a liability to TWM.

Applying the first prong of the constructive-dividend test, the court held that the transfer of funds from WSS to TWM lacked any *indicia* of bona fide indebtedness. There was no formal documentation evidencing a loan, no sinking fund, no security provided, and no personal guarantees. In addition, there was testimony that the loan was to be "repaid out of TWM's hopes for future profits." Thus, the court moved to the second prong of the test.

Applying the second prong, the court agreed with the IRS that the transfer of funds from WSS to TWM primarily benefited the shareholders because:

- WSS was a source of risk capital for TWM without using the shareholders' personal funds;
- The shareholders could carry on a business with extremely thin capitalization without having their personal funds subordinated to TWM's substantial debt;
- The shareholders could use the money in WSS interest-free;
- The shareholders' equity interest in TWM was greatly enhanced by the transfer of funds; and
- The shareholders were relieved of potential liability on their personal guarantees of loans to TWM, which were partially paid off with the funds transferred by WSS.

Further, the court found that no corporate business purpose existed for the loan from WSS to TWM. The court found that for a corporate business purpose to exist, there must be a relationship between the transferor corporation and the transferee corporation such that the loan is in the best interest of the transferor corporation at the corporate level. In this case, the court determined that the only relationship between WSS and TWM was common ownership, and consequently there was no corporate purpose for WSS to loan the money.

Because, as described above, there was a direct and primary benefit to the shareholders from the $420,000 transfer from WSS to TWM and there was no business purpose for it, the court held that the transfer was not a loan and instead was a constructive dividend to the shareholders. The court did emphasize that "[t]he mere fact of common ownership, however, does not automatically mandate constructive dividend treatment." On appeal, the Sixth Circuit agreed with the Tax Court's analysis and affirmed.

Other cases involving constructive dividends

In other cases, the courts have likewise held that intercompany transfers were not bona fide indebtedness and were made primarily for the benefit of the shareholders, so they constituted constructive dividends.[6] Before discussing these cases, it is important to note how corporate distributions are taxed.

EXECUTIVE SUMMARY

- An intercompany loan between related corporations may be recharacterized as an equity contribution to the corporation receiving the loan, resulting in a constructive dividend to the corporations' shareholders. This can happen if the loan is not bona fide and was made to benefit the shareholders rather than the lender corporation.

- Whether the related corporations are C corporations or S corporations, recharacterization of the intercompany loans as constructive dividends may result in the loan being treated as a taxable dividend or distribution to the shareholders of the corporations.

- In the recent case of *Estate of Fry*, the Tax Court held that purported loans between two commonly owned S corporations instead were constructive dividends from the lending corporation to the sole shareholder and corresponding capital contributions by him to the other company.

- In cases involving the recharacterization of intercompany loans, the shareholder usually argues for loan treatment to avoid the income that will result from the loans being treated as constructive dividends. In *Fry*, however, the shareholder argued for the loans being constructive dividends followed by equity contributions to the corporation receiving the loans, as this would increase that corporation's basis and allow him to deduct more of its losses.

- Taking steps to address questionable intercompany "loan" transactions can help avoid potential IRS challenges.

6. See, e.g., *McLemore*, T.C. Memo. 1973-59, aff'd *per curiam*, 494 F.2d 1350 (6th Cir. 1974), and *Kelly*, T.C. Memo. 2021-76, discussed below.

The taxation of C corporation distributions to shareholders (including constructive distributions) is governed by Sec. 301(c). Under Sec. 301(c),[7] distributions are first considered ordinary dividends, as defined in Sec. 316,[8] then are applied against and reduce shareholder basis in stock, and any amount in excess of shareholder stock basis is treated as gain from the sale or exchange of property.

In contrast, S corporation distributions to shareholders (including constructive distributions) are governed by Sec. 1368.[9] Distributions by S corporations are divided into those of (1) S corporations having no Subchapter C earnings and profits[10] and (2) S corporations having Subchapter C earnings and profits.[11] In brief, if an S corporation does not have Subchapter C earnings and profits, a distribution is included in the shareholder's gross income only to the extent that the distribution exceeds the shareholder's adjusted basis of the stock.[12] Any amount in excess of the shareholder's adjusted basis in the stock is treated as gain from the sale or exchange of property.[13]

In comparison, S corporations that have Subchapter C earnings and profits are required to maintain an accumulated adjustments account (AAA) that tracks items of income and deductions similar to the adjustments in Sec. 1367[14] (dealing with stock and debt basis), except tax-exempt income and any related expenses.[15] Only a distribution that exceeds the AAA is included in the shareholder's gross income.[16]

A distribution that exceeds the AAA is treated as an ordinary dividend to the extent of the S corporation's Subchapter C earnings and profits.[17] A distribution in excess of the S corporation's Subchapter C earnings and profits is applied against the shareholder's adjusted basis in stock,[18] with any amount in excess of shareholder stock basis treated as gain from the sale or exchange of property.[19]

In *McLemore*,[20] the Tax Court again held that intercompany transfers were constructive dividends. Robert McLemore was the 100% shareholder of two corporations, Clark County Motors (Motors) and McLemore Realty Company (Realty). Motors' business was run out of a building it leased from Realty. In 1958, Motors sustained a series of losses and never regained profitability until it eventually sold its assets.

In 1964, McLemore learned from Motors' manager that it owed $60,000 on an automobile floor plan financing agreement with First National Lincoln Bank. McLemore borrowed $60,000 from the same bank, which he loaned to Motors. Motors used the loan proceeds to pay the amounts that were due under its floor plan financing agreement.

Subsequently, Realty borrowed $100,000 from another bank. Of that amount, Realty advanced $60,000 to Motors in exchange for a demand note. In turn, Motors transferred the $60,000 to McLemore to pay off the loan it had received from him. McLemore used the $60,000 to pay off the initial loan he had taken out from First National Lincoln Bank so he could make the loan to Motors.

The Tax Court held that Realty's transfer to Motors primarily benefited McLemore and that it was a constructive dividend to him. Realty claimed it made the loan to Motors for the business purpose of preserving Motors as a viable tenant of its property. The court, however, found that this was not the true reason for the loan, given Motors' poor financial condition at the time. Instead, the court determined that Realty's loan to Motors was merely a device to enable McLemore to extract $60,000 from Realty at no tax cost to him to satisfy his personal obligation to First National Lincoln Bank. Thus, the loan primarily benefited McLemore. On appeal, the Sixth Circuit affirmed, agreeing with the Tax Court's analysis.

In *Kelly*,[21] a complex case involving many related entities (both C corporations and S corporations) with many intercompany loans, the court held that the intercompany loans were not properly characterized as loans but were constructive dividends to the common shareholder of the related entities. The court's primary reason for finding that the loans in question were constructive dividends was that when the purported loans were made, given the state of the economy, there was no reasonable prospect that they could be repaid.

In contrast, in *Joseph Lupowitz Sons, Inc.*,[22] the Third Circuit affirmed the Tax Court's holding that advances between related corporations were bona fide indebtedness, even though there was no express agreement regarding repayment of principal or payment of interest on the transferred funds. The Tax Court in this case was convinced that a true obligation existed between the corporations. The transfers between the corporations were treated as loans by both the lender

7. "Amount taxable."
8. "Dividend defined."
9. "Distributions."
10. Sec. 1368(b).
11. Sec. 1368(c).
12. Sec. 1368(b)(1).
13. Sec. 1368(b)(2).
14. "Adjustments to basis of stock of shareholders, etc."
15. Sec. 1368(e)(1)(A).
16. Sec. 1368(c)(1).
17. Sec. 1368(c)(2).
18. Sec. 1368(c)(3).
19. Id.
20. *McLemore*, T.C. Memo. 1973-59, aff'd *per curiam*, 494 F.2d 1350 (6th Cir. 1974).
21. *Kelly*, T.C. Memo. 2021-76.
22. *Joseph Lupowitz Sons, Inc.*, 497 F.2d 862 (3d Cir. 1974).

If the adviser is fortunate enough to have a client who seeks advice in advance, avoiding intercompany loans in the first place would be preferable.

corporation and the borrower corporation. In addition, the "transferred funds were not siphoned off to or for the benefit of the taxpayers [shareholders]."

The Tax Court also found that the fact the shareholder derived the benefit of being able to use the lender corporation's money on an interest-free basis was not, in itself, sufficient to find that an intercompany loan between related corporations was a constructive dividend to the corporations' shareholders rather than a bona fide loan to the corporation receiving the transfers. Furthermore, the business purpose for the loans could be a general, rather than a specific, business purpose.

Estate of Fry

This discussion turns now to the Tax Court's recent decision in *Estate of Fry*,[23] which illustrates the importance of cleaning up intercompany debt but has an unusual twist. The court's opinion provides instructive tutorials on debt-equity determinations (Sec. 385), substance over form, S corporation shareholder tax basis determinations, burden of proof, and planning opportunities for cleaning up or dismantling intercompany debt. The facts of *Estate of Fry* are commonplace and should resonate with many tax practitioners.

Thomas H. Fry (deceased at the time of trial) was the shareholder of two S corporations, Crown Disposal Inc. (Crown) and CR Maintenance Services Inc. (CR Maintenance). Crown was a trash collector, and CR Maintenance processed the trash collected by Crown, recycled the trash, and converted it into other commodities for third parties. The companies operated in the same facility and conducted an integrated operation. Crown did not pay CR Maintenance for taking possession of the waste and did not share fees with CR Maintenance.

Following the loss of a significant contract with the City of Los Angeles in 2011, CR Maintenance suffered financial losses of between $5 million and $7 million annually. To fund CR Maintenance's losses, funds were transferred directly from Crown to CR Maintenance; i.e., Crown did not first distribute the funds to Fry with a corresponding capital contribution to CR Maintenance. CR Maintenance used the transferred funds to pay general operating expenses. In addition, Crown also paid CR Maintenance's creditors directly for certain expenses. At the close of 2013, the total of the transfers and payments to creditors was $36,255,141. The transfers from Crown to CR Maintenance and the payments to its creditors were recorded as liabilities on CR Maintenance's tax returns.

CR Maintenance did not provide any promissory notes regarding the transfers of funds or the payments to its creditors and did not have any written due dates for a return of the money. Crown did not request, and CR Maintenance did not provide, a security interest for the transfers and payments, and CR Maintenance did not make or promise to make any interest payments related to the transfers and payments. By the end of 2013, CR Maintenance had repaid Crown for only a small portion of the payments to creditors that Crown had made on its behalf.

For 2013, the tax year at issue,[24] CR Maintenance filed Form 1120-S, *U.S. Income Tax Return for an S Corporation*, and reported an ordinary loss of $5,650,651. Fry's tax basis in his CR Maintenance stock before any losses was only $2,438.[25] Nevertheless, Fry deducted a passthrough loss from CR Maintenance on his joint 2013 Form 1040, *U.S. Individual Income Tax Return*, of $4,733,675. Fry's debt and stock basis in Crown at the end of 2013 were $42,724,064 and $584,500, respectively.[26] The IRS disallowed $3,457,444 in passthrough losses from CR Maintenance for lack of basis (later reducing that amount to $3,455,006 to reflect Fry's $2,438 in basis in CR Maintenance).[27]

Fry argued, somewhat unusually, that the transfers from Crown and its payments to CR Maintenance's creditors were not bona fide debt, despite how his companies had characterized them on their tax returns. Instead, Fry argued, these transfers and payments were constructive dividends from Crown and constructive equity contributions to

23. *Estate of Fry*, T.C. Memo. 2024-8.
24. The statute of limitation for the tax years 2008 through 2012 and 2014 through 2019 had expired.
25. Id., slip op. at 6–7 for a summary of stock basis in CR Maintenance.
26. Id., slip op. at 7 for a summary of stock basis in Crown.
27. Id., slip op. at 8. The IRS initially allowed Fry $1,276,231 in losses because it agreed that Fry had that amount of debt basis in CR Maintenance, although it is not clear from the Tax Court's opinion how the IRS arrived at the amount.

In general, the courts use a two-prong test to determine whether intercompany loans between commonly owned corporations are constructive dividends.

CR Maintenance. Under this argument, Fry had sufficient stock basis in CR Maintenance to deduct the full amount of its passthrough losses for 2013 on his joint return with his spouse for the year. In addition, because Fry had stock basis in Crown in excess of the amounts of transfers to and payments made for CR Maintenance, Fry would not recognize additional income if they were recharacterized as constructive dividends.

The IRS argued that Fry had insufficient stock basis to deduct passthrough losses from CR Maintenance, claiming that he was prohibited from characterizing the transfers and payments to CR Maintenance as equity because Fry and his spouse "had the prior opportunity to characterize the Transfers and the Payments as equity when filing their tax returns and preparing their financial documentation, but they elected to treat the Transfers and the Payments as loans."

The IRS also argued that, under Sec. 385(c), Fry was prohibited from recharacterizing the transfers and payments from debt to equity.[28] Sec. 385(c) provides that the characterization at the time of issuance by the issuer regarding whether an interest in a corporation is stock or debt is binding upon the issuer and on all holders but is not binding upon the IRS.[29] Thus, according to the IRS, Fry was bound by Crown's and CR Maintenance's characterization of the transfers and payments as debt on their tax returns and general ledgers.

Application of Sec. 385(c)

Regarding this issue, the court held for the taxpayers, stating that Sec. 385(c) applies only if there was a "formal issuance of any instrument evidencing the creation of an interest in stock or equity."[30] In this case, no promissory note or stock certificate was issued; therefore, Sec. 385(c) was inapplicable. After rejecting the Sec. 385(c) argument, the court proceeded to analyze whether the transfers and payments were debt or equity under established judicial principles.

Substance-over-form doctrine

Before analyzing the various relevant factors in determining whether the transfers and payments were constructive dividends and constructive contributions to capital, the court made a brief reference to the substance-over-form doctrine. The court stated, as the Supreme Court held in *Gregory v. Helvering*,[31] that the substance of a transaction, not its form, controls the characterization of a taxable transaction. The court also quoted the Ninth Circuit's decision in *Bauer*, in which the Ninth Circuit stated, "The outward form of the transaction is not controlling; rather, characterization depends on the taxpayer's actual intent, as evidenced by the circumstances and conditions of the advance."[32]

With respect to the substance-over-form doctrine, the court's deference to the taxpayers is perplexing. There is long-standing judicial precedent that, absent strong proof or absent a showing of fraud or undue influence, a taxpayer is essentially bound by an agreement's form, and only the government can assert that the substance of the transaction will control.[33] In *National Alfalfa Dehydrating & Milling Co.*, the Supreme Court stated, "[t]his Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not … and may not enjoy the benefit of some other route he might have chosen to follow but did not."[34] Nonetheless, the Tax Court proceeded with its debt vs. equity analysis.

Debt vs. equity analysis

Because appeal of this case lies in the Ninth Circuit (the Frys resided in California), the Tax Court cited *Hardman*,[35] a Ninth Circuit case, which identified 11 relevant factors for determining whether a transfer to a corporation is indebtedness or a contribution to capital.[36] Those factors are:

28. Although Sec. 385 is located in Subchapter C of the Internal Revenue Code, Sec. 1371(a) provides that Subchapter C applies to S corporations and its shareholders.
29. Sec. 385(c)(1).
30. *Estate of Fry*, slip op. at 12, citing *Hardman*, 827 F.2d 1409 (9th Cir. 1987).
31. Quoting *Gregory v. Helvering*, 293 U.S. 465, 469–70 (1935).
32. *Bauer*, 748 F.2d 1365, 1367–68 (9th Cir. 1984), rev'g T.C. Memo. 1983-120.
33. *Danielson*, 378 F.2d 771 (3d Cir. 1967).
34. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 150 (1974).
35. *Hardman*, 827 F.2d 1409, 1411–12 (9th Cir. 1987).
36. *Estate of Fry*, slip op. at 13.

Unwinding the transactions can be complicated and problematic, especially where there is little or no likelihood of repayment.

- The presence or absence of a maturity date;
- The source of the payments;
- The right to enforce the payment of principal and interest;
- Whether the "lender" has a status equal or inferior to that of regular creditors;
- The extent to which the funds advanced are proportional to the shareholder's capital interest;
- The extent to which interest payments come from "dividend" money;
- Objective indicators of the parties' intent;
- The names given to the certificates evidencing the debt;
- Whether the advances increase participation in management;
- Whether the capital structure of the "borrower" is thin or adequate; and
- The ability of the "borrower" to obtain loans from outside lending institutions.

Applying these factors to Crown's transfers to and payments for CR Maintenance showed that the first six factors favored a finding of equity, the seventh favored a finding of debt, and the last four were neutral. After weighing the factors in the context of the case, the court determined that it was more likely than not that the transfers and payments were not bona fide indebtedness. Thus, the first prong of the constructive-dividend test was met.

The court then proceeded to the second prong, i.e., whether the transfers and payments primarily benefited Fry. If they did, then they would be recharacterized as constructive dividends from Crown to Fry and subsequent capital contributions by him to CR Maintenance.

Again, relying on Ninth Circuit case law, the court stated that a two-part test applies in determining whether a transfer between commonly owned corporations primarily benefits the common shareholders in the corporations. A transfer primarily benefits the common shareholders if (1) the expenditures do not give rise to a deduction to the distributing corporation; and (2) the expenditures create "economic gain, benefit, or income" to the shareholders.[37] In the case of the transfers to and payments made for CR Maintenance by Crown, the court concluded that both requirements of this test were satisfied.

Regarding the first requirement, the Tax Court explained that under it, the court looks to see if there was some benefit to the corporation making a transfer or payment. A benefit would be conferred if the transfer or payment results in a deduction for the corporation making it. There was, in the court's view, no discernable business reason for the transfers of funds by Crown to CR Maintenance, and thus, Crown would not be entitled to a business deduction for them. Regarding Crown's payments to CR Maintenance's creditors, while business deductions could be taken, they could be taken only by CR Maintenance, not Crown. Thus, the first requirement of the test was met.

The Tax Court found that for the second requirement to be met, shareholders must receive an actual, direct benefit. Based on Tax Court precedent, the court stated, where there is no discernable business reason to make a loan between related entities because there was no expectation of interest or repayment, the primary benefit is to the shareholders. Also, where a loan made between related corporations allows the corporation to which the transfers are made to remain a viable and profitable business, the primary benefit is to the shareholders.

As the Tax Court observed, Crown had no discernable reason to make the transfers to or payments for CR Maintenance because it could not expect to receive interest on or repayment of them. Moreover, because of the interlinked business operations of Crown and CR Maintenance, Crown would not be a viable, profitable company in the absence of CR Maintenance, and the transfers allowed CR Maintenance to remain operating. Also, the transfers and payments benefited Fry by allowing him to avoid using his personal funds to support CR Maintenance and to continue to collect salary and rent from CR Maintenance. Thus, the court found that Crown's transfers to and payments made for CR Maintenance created an economic benefit to Fry, the shareholder of the corporations.

Both requirements of the test being met, the Tax Court held that the transfers and payments were constructive dividends from Crown to Fry and capital contributions from Fry to CR Maintenance.

The taxpayers in *Estate of Fry* were fortunate. The Tax Court generously

37. *P.R. Farms, Inc.*, 820 F.2d 1084, 1088 (9th Cir. 1987) (quoting *Meridian Wood Prods. Co.*, 725 F.2d 1183, 1191 (9th Cir. 1984)), aff'g T.C. Memo. 1984-549.

The distribution and contribution should be accompanied by the appropriate legal documentation in addition to the accounting journal entries.

applied the substance-over-form doctrine in their favor to recharacterize the form of the transactions. The recharacterization resulted in an increase to Fry's tax basis in CR Maintenance, which allowed for the deduction of the full passthrough losses from CR Maintenance on Fry's personal tax return. Furthermore, because Fry's stock basis in his Crown stock was greater than the total amount of the transfers and the payments Crown made, their recharacterization came at no tax cost to Fry.

Concluding thoughts

The *Estate of Fry* litigation could have been avoided had Fry proactively and timely distributed the money for the transfers and payments from Crown to himself; documented and recorded that he made a contribution to capital to CR Maintenance in 2013; and properly reported these transactions on the returns for Crown, CR Maintenance, and his personal returns. In that case, the substance of the transactions would then have comported with their form as reported on the returns.

If an adviser is fortunate enough to have a client who seeks advice in advance, avoiding intercompany loans in the first place would be preferable. Shareholder capital infusions to a financially struggling corporation can provide the client with additional tax basis in the corporation and avoid any intercompany loan issues.

Where intercompany loans among related entities already exist and there is little expectation of repayment, the client may want to consider distributing the loan receivable to the shareholder, followed by a contribution to capital to the debtor company. The distribution and contribution should be accompanied by the appropriate legal documentation in addition to the accounting journal entries. If the distributing corporation is an S corporation, a detailed shareholder stock basis calculation should be prepared to determine whether the distribution will exceed the shareholder's basis in the corporation or constitute a tax-free return of basis. ■

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