STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions	:	
of	:	
THOMAS AND LINDA LEON DANIEL LEON AND ALISON KOOBA JONATHAN LEON	:	DETERMINATION DTA NOS. 822339, 822340 AND 822341
for Redetermination of Deficiencies or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 2003, 2004 and 2005.	:	

Petitioners, Thomas and Linda Leon, Daniel Leon and Alison Kooba[1] and Jonathan Leon, filed petitions for redetermination of deficiencies or for refund of personal income tax under Article 22 of the Tax Law for the years 2003, 2004 and 2005.

A hearing was held before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York, on March 27, 2009, at 10:30 A.M., with all briefs submitted by July 13, 2009, which date began the six-month period for the issuance of this determination. Petitioners appeared by Dickstein Shapiro LLP (Lawrence D. Garr, Esq., of counsel). The Division of Taxation appeared by Daniel Smirlock, Esq. (Marvis A. Warren, Esq., of counsel).

---

[1]Alison Kooba is listed as a petitioner because she filed jointly with her spouse, Daniel Leon, during the years in issue. She owned no interest in Apothecus Pharmaceutical Corp. and did not sign the promissory note in issue. Unless otherwise noted, all references to petitioners shall be to Thomas and Linda Leon, Daniel Leon and Jonathan Leon.

ISSUE

Whether certain flow-through losses deducted by petitioners on their individual resident income tax returns for the years in issue were properly disallowed by the Division of Taxation because petitioners lacked sufficient shareholder basis to justify said deductions.

FINDINGS OF FACT

The parties entered into a Stipulation of Facts, dated March 17, 2009, containing ten numbered paragraphs, all of which have been incorporated into the Findings of Fact below.

1. During 2003, 2004 and 2005 (the audit period), petitioners owned Apothecus Pharmaceutical Corp. (Apothecus), a New York corporation that was incorporated in 1974. For each of the years in the audit period, Apothecus elected to be taxed as a Subchapter S corporation under federal tax law and New York tax law.

2. Apothecus was a closely held corporation, entirely owed by petitioners, and held during the audit period in the following percentages:

Thomas Leon, 26.23%
Linda Leon, 4.87%
Daniel Leon, 43.9%
Jonathan Leon, 25%

3. Apothecus was in the business of manufacturing and selling over-the-counter pharmaceutical products. Its customers included national chain stores such as Walmart, Target, Walgreens, RiteAid and CVS. Apothecus was a small corporation, with a net worth of about $85,000.00 in 2001. In order to effectively compete with suppliers like Johnson & Johnson and other large merchants, the decision was made to purchase an aircraft to service its accounts, which were geographically diverse.

4. Apothecus Aviation LLC (Aviation) was a Delaware limited liability corporation that was formed to purchase and maintain the aircraft. Aviation was a single member limited liability corporation whose only member was Apothecus.

5. To keep costs down, it was decided to purchase an older aircraft. In 2001, Aviation purchased a 1984 Cessna Citation III aircraft for $4,125,000.00. To manage the costs of the purchase, Aviation needed to finance a large portion of the purchase price and extend the amortization period to 25 years. Its efforts to obtain financing with these terms met with no success with traditional lenders such as CITI Bank, GE Capital, FleetBoston and Bank of America.

6. After the unsuccessful attempts to find financing on affordable terms, Thomas Leon contacted a loan officer, Joseph Hanser, at the First Interstate Bank in Billings, Montana, with whom he had a long-standing and substantial business relationship. Mr. Hanser, a senior vice president with the bank, was able to convince the bank to make the loan to Aviation, supported by a promissory note in the sum of $3,512,870.00, a security interest in the aircraft and other property related to the aircraft and Daniel and Linda Leon's relationship with the bank. Mr. Hanser was able to accomplish this even though First Interstate Bank's primary lending area is Montana, Wyoming and western South Dakota, and loans to corporations outside that area were rare.

The promissory note, which named Aviation as the borrower, was executed on August 27, 2001 and stated a maturity date of September 1, 2006. It was signed by Thomas Leon, Linda Leon and Daniel Leon on behalf of Aviation and also cosigned by Thomas Leon, Linda Leon, Daniel Leon and Jonathan Leon as individuals.

The Aircraft Security Agreement, dated October 5, 2001, set forth Aviation as the borrower and the grantor of the security interest in the aircraft and related property and listed Thomas Leon, Linda Leon and Daniel Leon as signatories on behalf of the corporation.

7. Thomas and Linda Leon met Mr. Hanser in 1988 or early 1989 when purchasing a ranch in Montana. Since that time, Mr. Hanser and First Interstate Bank made many loans to them for the operation of the ranch, the purchase of equipment and livestock. In addition, Thomas and Linda Leon and their companies became major depositors in the bank. The Leons have never been late on any of their loan payments. This strong relationship, which spanned several decades, was part of the inducement for First Interstate Bank to lend Aviation the funds necessary to purchase the aircraft, despite the fact that it did not finance aircraft in the ordinary course of its business and did not maintain an aircraft financing department.

8. Although Aviation was listed as the borrower on the promissory note and granted First Interstate Bank the security interest in its aircraft and related property, the bank also required petitioners to co-sign the note. At the end of the note, there was set forth a "Notice to Cosigners," which explained to petitioners that, by signing the note, they guaranteed payment if Aviation failed to pay the debt, up to the full amount of the note. The notice also stated that, in the event of a failure to pay the debt, the bank had the right to seek payment from the co-signers without first trying to collect from Aviation. However, the co-signers did not pledge any of their own personal property as collateral for the loan. Mr. Hanser testified that the bank believed petitioners were "ultimately liable" for payment of the loan, consistent with the provisions of the "Notice to Cosigners."

9. The aircraft and property related to the aircraft were the only assets of Aviation. As a result, due to interest paid on the note and depreciation expense on the aircraft, Aviation's

operations reflected losses during the audit period, which were accounted for on the returns filed by Apothecus.

10. Aviation reported the loan from First Interstate Bank first on its trial balance, a list of all debit and credit accounts, for the fiscal year ended November 30, 2004. In turn, because Aviation is a single member LLC owned by Apothecus, it is a disregarded entity for tax purposes and all of its activities are reported on Apothecus's return. Hence, the loan from First Interstate Bank to Aviation appears as an element of "Current portion of long-term debt" on the consolidated balance sheet of Apothecus for the year ended November 30, 2005.

11. Nothing contained in the federal forms 1120S indicate that petitioners ever made loans to Apothecus or contributed to capital, as reflected in the schedule L (balance sheet) attached to its returns filed during the audit period. In each of the years in issue, there was no entry for either "Loans from shareholders" or "Additional paid-in capital" set forth on the balance sheet.

12. None of the petitioners received the First Interstate Bank loan proceeds granted to Aviation for purchase of the aircraft, and Mr. Thomas Leon never made payments on the loan from his personal bank account. The bank never requested that any of the petitioners make payments on the loan in their cosigner capacity. Because all payments on the loan were timely made by Aviation, there was never a need for the bank to resort to any of the default remedies provided for in the note.

13. At no time during the audit period did Mr. Thomas Leon execute his own promissory note to the bank to be substituted for the note issued by Aviation. However, in November 2007, after the years in issue, petitioners applied for and received a loan from First Interstate Bank, the proceeds of which were received by petitioners then loaned to Apothecus, which loaned the funds to Aviation. Aviation then satisfied the original loan.

14. On or about August 24, 2006, the Division of Taxation (Division) began an audit of Apothecus for the audit period that continued for approximately eight months and determined that the corporation had no additional tax due. However, in examining the books and records of Apothecus, the Division found that it did not appear that the shareholders had sufficient basis to deduct the flow-through losses on their personal income tax returns. In its audit report the Division noted:

> In the computation of the shareholders basis the taxpayer included bank loan made to the Apothecus Aviation, LLC to increase the basis of shareholders. Without the bank loan, the basis of the shareholders would be zero for tax years 2003, 2004 and 2005.
>
> Taxpayer argued that since the shareholders cosigned the bank note that the shareholders should get basis in the s-corporation. However, audit determined that since the shareholders did not have any economic outlay, they were not entitled to increase their basis with the bank loan. Therefore the flow-through losses for the tax years 2003, 2004 and 2005 were disallowed.

15. On January 18, 2007, the Division sent a letter to Thomas and Linda Leon, Daniel Leon and Jonathan Leon which informed them that an audit of their income tax returns for the years in issue had resulted in an increase to their tax liability. The letters also included consents to field audit adjustment forms for their signatures should they agree with the findings and an invitation to contact the Division if they disagreed. The letter and 12 pages of attachments set forth in detail the Division's calculation of additional tax and stated that the basis for the increase in tax liability was disallowed K-1 losses from Apothecus Pharmaceutical due to insufficient shareholder basis.

16. The Division of Taxation issued to petitioners notices of deficiency, dated May 14, 2007, which set forth the following additional tax due pursuant to the adjustments for the audit period:

	Assessment ID	Tax	Interest	Total
Thomas and Linda Leon	L-028562054-6	$59,579.00	$13,016.78	$72,595.78
Daniel Leon and Alison Kooba	L-028561949-8	$113,483.00	$20,613.74	$134,096.74
Jonathan Leon	L-028561333-8	$52,075.00	$9,564.88	$61,639.88

The differences in the tax due from each of the petitioners apparently coincides with their ownership percentage as set forth above.

SUMMARY OF THE PARTIES' POSITIONS

17. Petitioners maintain that the substance of the loan transaction with First Interstate Bank was revealed in the evidence and testimony adduced at the hearing and that, although the documentation indicated Aviation was the direct recipient of the loan, it was, in fact, a loan to petitioners. Petitioners rely upon ***Selfe v. United States*** (778 F2d 769 [11th Cir 1985]) in support of their argument that subchapter S shareholders are entitled to an increase in their bases where a bank loaning funds to their subchapter S corporation looks primarily to the shareholders for repayment.

18. Petitioners concede that the loan transaction was not reported as a shareholder loan or contribution to capital, but argue that this is irrelevant since the bank approved the loan to petitioners, required them to cosign the loan and made it clear that petitioners were primarily responsible for payment, not an undercapitalized company headquartered thousands of miles away. Further, petitioners argue that they received no tax or other benefit by having Aviation on the loan documents.

19. The Division of Taxation urges that petitioners should be bound by the form of the transaction which they chose. It argues the ***Selfe*** case has not been followed generally by the other circuits and that, in any event, the facts are distinguishable from those presented herein.

20. The Division of Taxation believes that petitioners did not increase their bases in the corporation by cosigning the promissory note because they made no economic outlay as required by case law.

CONCLUSIONS OF LAW

A. Internal Revenue Code (IRC) § 1366 provides:

> In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends . . . , there shall be taken into account the shareholder's pro rata share of the corporation's --
>
> (A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and
>
> (B) nonseparately computed income or loss. (IRC § 1366[a][1][A][B].)

The Code specifies special rules for losses and deductions passed through to shareholders, including that losses and deductions cannot exceed the adjusted basis of the shareholder's stock in the S corporation and the shareholder's adjusted basis of any indebtedness to the shareholder. (IRC § 1366[d][1][A], [B].)

In determining New York adjusted gross income and taxable income of a resident shareholder of an S corporation, any modification relating to an item of the corporation's income, gain, loss or deduction is made in accordance with the shareholder's pro rata share, for federal income tax purposes, of the item to which the modification relates. Those items not required to be taken into account separately for federal income tax purposes are determined in accordance with the shareholder's share of the S corporation's taxable income or loss generally. (Tax Law §

617[a].) An S corporation's items of income, gain, loss or deduction for New York purposes retain the same character for the shareholder as they did for federal income tax purposes. (Tax Law § 617[b].) Therefore, New York has adopted the federal rules and if petitioners can substantiate that their claimed losses and deductions do not exceed the sum of their adjusted basis in stock and adjusted basis in debt owed by Apothecus to them, then they will prevail.

B. The gravamen of petitioners' argument is that the bases in their shares of stock in Apothecus were increased by their investment of the funds received from the First Interstate Bank loan, thereby justifying their claim to the pass-through losses. In support of this position they cite ***Selfe v. Commissioner of Internal Revenue***, a 1985 Eleventh Circuit decision which held that a loan guaranteed by a shareholder on behalf of the S corporation constituted indebtedness for purposes of increasing the shareholder's adjusted basis in the shareholder's stock in the corporation. However, the facts in ***Selfe*** distinguish it from the instant case and the reasoning is suspect, as noted in several cases decided since its issuance.

In ***Selfe***, the taxpayers deducted a loss from gross income which was generated by a pass through from their S corporation, Jane Simon, Inc. The government limited the loss based on the taxpayers' adjusted basis in the corporation. The taxpayers argued that they had increased their basis in the corporation by virtue of a loan made to the corporation, which was guaranteed by one of the taxpayers and further supported by a pledge of her private stock in an unaffiliated company. The taxpayers construed this arrangement to be a loan to them which was then contributed to the corporation, thus increasing their basis. The bank's loan officer averred that since the loan to the corporation was guaranteed by the taxpayers and secured by the taxpayers' pledge of stock, the bank was primarily looking to the taxpayers and the pledged stock for repayment of the loan.

The Eleventh Circuit said that an economic outlay is required before a stockholder in an S corporation may increase its basis, but did not believe that a shareholder had to absolve a corporation's debt before recognizing an increased basis as a guarantor of a loan to the corporation. The Court qualified its conclusion by noting that a guarantor who had pledged stock to secure a loan had experienced an economic outlay to the extent that the pledged stock was not available as collateral for other investments and that the guarantor had lost the time value or use of the collateral. The Court only went so far as to say that a shareholder who guarantees a loan to a subchapter S corporation *may* increase her basis where the facts demonstrate that, in substance, the shareholder has borrowed funds and subsequently advanced them to the corporation. Since the result in ***Selfe*** was that the matter was remanded to the District Court for a determination of whether the bank loan to the S corporation was in reality a loan to the shareholder, there was no final resolution of the issue, only the possibility that under certain circumstances a guarantee could constitute indebtedness and justify an adjustment in the basis of the shareholder's stock.

Petitioners contend that the facts in this matter are sufficiently similar to those in ***Selfe*** to warrant the conclusion that the loan in question was, in substance, made to them and not the corporation. But petitioners ignore significant factual differences. First, although petitioners guaranteed the loan from First Interstate Bank to Aviation, they made no economic outlay. They pledged none of their own property as security for the loan or inducement for the bank. It was the aircraft, owned by Aviation and valued at $4,125,000.00, which the bank required as security for its loan of $3,512,870.00. Petitioners' historical relationship with the bank was an intangible with undetermined value that contributed to the bank's decision to make the loan, but the evidence does not support the contention that it was a primary reason.

When asked directly if the bank considered petitioners "primarily liable" on the loan, First Interstate Bank's loan officer, Mr. Hanser, testified that the bank believed petitioners were "ultimately liable" for the payment of the loan. This answer suggested a secondary role for petitioners with respect to their liability on the note. In fact, according to Mr. Hanser, the arrangement on this loan was no different than it would have been for any other newly formed small business, i.e., the bank would demand a guarantor or cosigner for the loan. However, the bank's interest was well secured by an asset the value of which exceeded the amount of the loan by more than $600,000.00.

It is noted that the bank officer who testified in ***Selfe*** was very clear on this point, as opposed to Mr. Hanser. That bank officer flatly stated that the bank was primarily looking to the taxpayer and the pledged stock for repayment of the loan. Further, although Mr. Hanser stated that First Interstate Bank distinguished between cosigning and guarantees, the bank's own form in its "Notice to Cosigner" clearly stated that the cosigner was being asked to guarantee the debt. Nowhere did it say the cosigner was primarily liable for the debt and even stated that "if the borrower [Aviation] doesn't pay the debt, you will have to."

C. Despite his testimony to the contrary, Mr. Hanser was aware from his first contact with Mr. Thomas Leon that petitioners were seeking a loan to Aviation. Mr. Leon testified that, after unsuccessfully seeking funding for the aircraft, he sought out Mr. Hanser at First Interstate Bank, who told him then that the bank did not do business with New York *corporations* lacking sufficient net worth. Since the bank, characterized by petitioners as a conservative bank, never issued a commitment letter on this substantial loan, the only documentation left to speak for itself was the purchase agreement for the aircraft, the promissory note and the security agreement. Those documents indicated that Aviation contracted to purchase an aircraft which it then

financed with a loan from the bank, memorialized by a promissory note, that was co-signed by petitioners, who guaranteed the debt. Thereafter, Aviation, as owner of the aircraft, granted a security interest in the aircraft to the bank. The Consolidated Financial Statements of Apothecus for the year ended November 30, 1985 reported the loan from First Interstate Bank as a mortgage on aircraft payable, not a note payable to petitioners. In addition, there was no argument or evidence that the funds had been paid to petitioners and then loaned to the corporation. Thus, it is concluded that the bank did not view petitioners as the primary obligors.

D. The shareholders' guarantee of the bank loan to Aviation did not increase petitioners' bases in their stock for purposes of determining the limits on their claimed flow-through losses. The simplicity of this statement belies the extensive body of case law that has explored the thorny issues involving loan situations with S corporations and their shareholders. In ***Gleason v. Commissioner*** (92 TCM 250 [2006]), the Tax Court has summarized the salient points germane to the instant matter as follows:

> Fundamentally, a shareholder may obtain or increase basis in an S corporation only if there is an economic outlay on the part of the shareholder that leaves him or her 'poorer in a material sense.' [Citations omitted.] An economic outlay for this purpose includes a use of funds for which the taxpayer is directly liable in a purchase of S corporation shares, in an actual contribution of cash or property by the shareholder to the S corporation, or in a transaction that leaves the corporation indebted to the shareholder. [Citations omitted.] Stated otherwise, the shareholder must make an actual "'investment'" in the entity, ***Spencer v. Commissioner*** 110 T.C. 62, 78-79 [1998] [quoting legislative history at S. Rept. 1983, 85th Cong., 2d Sess. (1958), 1958-3 C.B. 922, 1141], thereby incurring a true 'cost', ***Borg v. Commissioner*** , 50 T.C. 257, 263 [1968].
>
> In general, no form of indirect borrowing, e.g., guaranty, surety, accommodation, comaking, pledge of collateral, etc., will give rise to the requisite economic outlay unless, until, and to the extent that the shareholder pays all or part of the obligation. [Citations omitted.] The Court of Appeals for the Eleventh Circuit recognizes a limited exception to this rule, permitting a shareholder's guaranty of a loan to an S corporation to effect an increase in basis 'where the lender looks to the shareholder as the primary obligor.' ***Sleiman v. Commissioner,*** 187 F.3d 1352, 1357 [11th Cir.

> 1999] [quoting ***Selfe v. United States,*** 778 F.2d 769, 774 (11th Cir. 1985)) ***affg.*** T.C. Memo. 1997-530. However, even the Court of Appeals for the Eleventh Circuit affirms the general principle requiring an economic outlay, concluding merely that when the shareholder is looked to as the primary obligor, he or she has in substance borrowed the funds and advanced them to the corporation. ***Sleiman v. Commissioner****, **supra*** at 1357; ***Selfe v. United States****, **supra*** at 772-773; see also ***Maloof v. Commissioner****, supra* at 651.

Since it has already been concluded that petitioners made no economic outlay which could be construed as a debt or equity contribution, provided no additional security or collateral of their own and did not demonstrate that the bank was looking to them as the primary obligors on the promissory note, they have not established a reason for adjusting their bases in their shares of stock in Apothecus.

E. Petitioners' business plan for Apothecus included the need for rapid and far-reaching transportation, which was met by the purchase of an aircraft. Aviation was formed to provide insulation for petitioners from liability in connection with ownership of an aircraft, and it was imperative that the LLC maintain ownership of it to receive the insulation sought. Since title was in Aviation, the bank was obliged to insist that the promissory note and security interest be in Aviation's name to perfect its security interest in the aircraft and protect its investment. A loan to petitioners alone would not have been secured and would be considerably more risky than a loan secured by an aircraft worth $600,000.00 more than the amount financed. Hence, the form of this transaction was consonant with the intent and best interests of both the bank and petitioners, achieving the goals of both parties. Petitioners received an advantageous position vis-a-vis their exposure to liability related to owning the aircraft. In ***107 Delaware Associates v. State Tax Commission*** (64 NY2d 935, 488 NYS2d 634), the Court of Appeals reversed the Appellate Division and reinstated the determination of the Tax Commission and the dissenting opinion of Justice Casey of the Appellate Division, saying:

> Having elected to conduct their businesses under this format, and having reaped the benefits thereof, the individual petitioners now seek to avoid any disadvantage arising out of the selected format. There is nothing irrational about the Tax Commission's determination which has the effect of binding the taxpayers to the form of business chosen by them. (***See e.g. Matter of Ormsby Haulers v. Tully***, 72 AD2d 845, 421 NYS2d 701.)

In this matter, petitioners have reaped the benefits of the business format they chose to gain insulation from liability in owning an aircraft. Their argument that the bank actually made the loan to them and not Aviation ignores the way the transaction was accounted for by petitioners on the federal and state subchapter S returns for the years in issue and the note, security agreement and purchase agreement, all of which are consistent with the business format they chose, and unsuccessfully tries to recharacterize the loan transaction to qualify for an adjustment to their bases in their shares of stock. As succinctly stated by the Court in ***Brown v. Commissioner*** (706 F2d 755):

> ...[w]e refuse to accept petitioners' contorted view of the transaction in furtherance of their 'substance over form' argument when, as the court below observed, 'the substance matched the form.' ... Petitioners are liable for the tax consequences of the transaction that they actually executed; they may not reap the benefits of some other transaction that they might have effected instead. [Citations omitted.]

F. The petition of Thomas Leon and Linda Leon is denied and the Notice of Deficiency, L-028562054-6, dated May 14, 2007, is sustained; the petition of Daniel Leon and Alison Kooba is denied and the Notice of Deficiency, L-028561949-8, dated May 14, 2007, is sustained; and the petition of Jonathan Leon is denied and the Notice of Deficiency, L-028561333-8, dated May 14, 2007, is sustained.

Dated: Troy, New York
January 7, 2010

/s/ Joseph W. Pinto, Jr.
ADMINISTRATIVE LAW JUDGE