

TAX UPDATE

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Documents for Podcast 013

One Debt or Two—S Corporation Debts on Open Accounts

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The Tax Court issued an interesting decision on August 25 in the case of *Brooks v. Commissioner* (TC Memorandum 2005-204). This podcast considers the general rules for repayments of S corporation debt that may have a basis less than face value, including the ordinary income treatment of debts not documented by a note (per Revenue Ruling 68-537) vs. the capital gain treatment of the gain on repayment of debt evidenced by a note (Revenue Ruling 64-162).

The *Brooks* case is contrasted with the case the IRS relied on, that of *Cornelius v. Commissioner* (58 TC 417, *aff'd* CA 5, 74-1 USTC ¶9446, 494 F2d 465, 33 AFTR 2d ¶74-1331). A discussion of the impact of Regulation 1.1367-2 is included in the podcast.

T.C. Memo. 2005-204

UNITED STATES TAX COURT

FLEMING G. AND SHERRY H. BROOKS, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

ESTATE OF FLEMING S. BROOKS, DECEASED, WILLIAM H. CARR AND MERLE
R. BROOKS, PERSONAL REPRESENTATIVES AND MERLE R. BROOKS,
Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 8981-03, 8983-03.¹ Filed August 25, 2005.

Jo Karen Parr, Alan E. Rothfeder, and Carla C. Gilmore, for
petitioners.

Marshall R. Jones and Robert W. West III, for respondent.

¹These cases are consolidated for purposes of briefing and opinion (hereafter collectively the instant case).

MEMORANDUM OPINION

WELLS, Judge: Respondent determined deficiencies in Federal income taxes for petitioners Fleming G. Brooks and Sherry H. Brooks in the case at docket No. 8981-03 as follows:

<u>Year</u>	<u>Deficiency</u>	<u>Addition to tax Sec. 6662(a)</u>
1999	\$207,552	\$997.60
2000	190,105	1,027.60

Respondent determined deficiencies in Federal income taxes and additions to tax for the Estate of Fleming S. Brooks and Merle R. Brooks in the case at docket No. 8983-03 as follows:

<u>Year</u>	<u>Deficiency</u>
1999	\$157,207
2000	163,910

After concessions, the issue to be decided is whether the advances of open account debt by petitioners to their closely held S corporation in 1999 and 2000 provided petitioners with basis to offset repayments of open account debt made by the company in 1999 and 2000, prior to each respective advance.²

²All section references are to the Internal Revenue Code, as amended, and all Rule references are to the Tax Court Rules of Practice and Procedure.

Background

The parties submitted the instant case fully stipulated, without trial, pursuant to Rule 122. The parties' stipulations of fact are incorporated herein by reference and are found as facts in the instant case.

Petitioners Fleming G. Brooks and Sherry H. Brooks are husband and wife. At the time of filing the petition, they resided in Samson, Alabama. During the years in issue, Fleming S. Brooks and Merle R. Brooks were husband and wife. Fleming S. Brooks died on March 30, 2001. At the time of filing the petition, Merle R. Brooks resided in Samson, Alabama. Fleming G. Brooks and Fleming S. Brooks (Messrs. Brooks) and their respective spouses were calendar year taxpayers.

At all relevant times, Fleming S. Brooks owned 51 percent of the stock of Brooks AG Company, Inc., (the company), and Fleming G. Brooks owned 49 percent. The company was an S corporation with a calendar year tax year, and Messrs. Brooks each had a zero basis in their stock in the company during all relevant times.

Before and during the years in issue, Messrs. Brooks advanced money to the company on open account on three occasions. The open account transactions and related computations of Messrs. Brooks are described in detail in the Appendix to this opinion. The first such advance occurred during 1997, when Messrs. Brooks each advanced \$500,000 to the company on open account (referred

to collectively as the \$1 million advance). The second advance occurred on December 31, 1999, when Messrs. Brooks each advanced \$800,000 to the company on open account (referred to collectively as the \$1.6 million advance). The third advance occurred on December 29, 2000, when Messrs. Brooks each advanced \$1.1 million to the company on open account (referred to collectively as the \$2.2 million advance). On January 5, 1999, the company made a \$500,000 repayment to each of Messrs. Brooks (referred to collectively as the \$1 million repayment). On January 3, 2000, the company made a \$800,000 repayment to each of Messrs. Brooks (referred to collectively as the \$1.6 million repayment).

As of the close of 1998, the outstanding balance of open account debt owed by the company to Messrs. Brooks equaled the amount advanced to the company during 1997; i.e., \$1 million. However, pro rata company losses during 1997 and 1998 had reduced Messrs. Brooks's basis in the open account debt to zero.

When Messrs. Brooks made the \$1.6 million advance at the close of 1999, it was an amount sufficient, in Messrs. Brooks's view, to (1) provide a basis offset for the \$1 million repayment and (2) allow for the recognition by Messrs. Brooks of their pro rata share of company losses incurred during 1999.³

³Petitioners contend that Messrs. Brooks's bases in the open account debts were also reduced by offsetting the \$1 million repayment. As discussed below, respondent contends that the repayment of open account debt may not be offset by the basis of
(continued...)

When Messrs. Brooks made the \$2.2 million advance at the close of 2000, it was an amount sufficient, in Messrs. Brooks's view, to (1) provide a basis offset for the \$1.6 million repayment and (2) allow for the recognition by Messrs. Brooks of their pro rata share of company losses during 2000.⁴

Respondent concedes that Messrs. Brooks's advances to the company and the company's repayments of the advances constituted open account debt and does not contend that any of the advances constituted separate indebtedness. Other than the advances described above, Messrs. Brooks advanced no money to the company from 1997 to December 31, 2000.

Discussion

We must decide whether the \$1.6 million advance provided sufficient basis to offset the \$1 million repayment on January 5, 1999, in addition to allowing recognition of Messrs. Brooks's pro rata share of company losses for 1999, and whether the \$2.2

³(...continued)
an open account advance subsequent to the repayment. However, respondent does not dispute that the \$1 million advance provided Messrs. Brooks with sufficient bases to recognize their respective pro rata losses for 1999.

⁴Petitioners contend that Messrs. Brooks's bases in the open account debts were also reduced by offsetting the \$1,600,000 repayment. As discussed below, respondent contends that the repayment of open account debt may not be offset by the basis of an open account advance subsequent to the repayment. However, respondent does not dispute that the \$1,600,000 advance provided Messrs. Brooks with sufficient bases to recognize their respective pro rata losses for 2000.

million advance provided sufficient basis to offset the \$1.6 million repayment on January 3, 2000, in addition to allowing recognition of Messrs. Brooks's pro rata share of losses for 2000.

A lender recognizes income to the extent that repayment of the debt exceeds the lender's basis in the debt. See sec. 1001(a), (c). Because a lender generally takes a basis equal to the face amount of the debt, a repayment generally does not generate taxable income to the lender. See secs. 1001(a), 1011(a), 1012. However, taxable income may result from the repayment of a debt if the lender's basis in the debt is reduced from the face amount. See sec. 1001(a). If a shareholder advances money to an S corporation and the shareholder's pro rata share of S corporation losses exceeds the shareholder's basis in the stock of the S corporation, a reduction in the basis of a debt may occur. See sec. 1367(b)(2)(A); sec. 1.1367-2(b), Income Tax Regs.

A shareholder of an S corporation must take into account the shareholder's pro rata share of the S corporation's items of income, loss, deduction, and credit.⁵ Sec. 1366(a)(1). Items of

⁵SEC. 1366(d). Special Rules for Losses and Deductions.--

(1) Cannot exceed shareholder's basis in stock and debt.--
The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of--

income increase the shareholder's basis in stock of the S corporation (stock basis), and items of loss decrease the shareholder's stock basis. Sec. 1367(a). In the instant case, Messrs. Brooks each had a zero basis in their stock in the company at all relevant times.

Although a shareholder may not reduce stock basis below zero, a shareholder with a zero stock basis may recognize further losses to the extent of the shareholder's debt basis, including the shareholder's advances to the S corporation. See sec. 1366(d)(1). Section 1367(b)(2)(A) and section 1.1367-2(b), Income Tax Regs., provide that a shareholder must reduce debt basis (but not below zero) to the extent that the shareholder's pro rata share of losses exceeds the shareholder's stock basis, after taking into account any income items for the tax year.⁶ In

⁵(...continued)

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

⁶Sec. 1.1367-2(b) Reduction in basis of indebtedness--

(1) General rule. If, after making the adjustments required by section 1367(a)(1) for any taxable year of the S corporation, the amounts specified in section 1367(a)(2)(B), (C), (D), and (E) (relating to losses, deductions, noncapital, nondeductible expenses, and certain oil and gas depletion deductions) exceed the basis of a shareholder's stock in the corporation, the excess
(continued...)

a year subsequent to such a reduction in debt basis, if the shareholder's pro rata share of income exceeds the pro rata share of losses, section 1367(b)(2)(B) and section 1.1367-2(c), Income Tax Regs., provide that the excess income shall first restore the shareholder's debt basis and then restore the shareholder's stock basis.⁷ The reduction of debt basis pursuant to section 1367(b)(2)(A) and section 1.1367-2(b), Income Tax Regs., and the

⁶(...continued)

is applied to reduce (but not below zero) the basis of any indebtedness of the S corporation to the shareholder held by the shareholder at the close of the corporation's taxable year. Any such indebtedness that has been satisfied by the corporation, or disposed of or forgiven by the shareholder, during the taxable year, is not held by the shareholder at the close of that year and is not subject to basis reduction.

⁷Sec. 1.1367-2(c) Restoration of basis--(1) General rule. If, for any taxable year of an S corporation beginning after December 31, 1982, there has been a reduction in the basis of an indebtedness of the S corporation to a shareholder under section 1367(b)(2)(A), any net increase in any subsequent taxable year of the corporation is applied to restore that reduction. For purposes of this section, net increase with respect to a shareholder means the amount by which the shareholder's pro rata share of the items described in section 1367(a)(1) (relating to income items and excess deduction for depletion) exceed the items described in section 1367(a)(2) (relating to losses, deductions, noncapital, nondeductible expenses, certain oil and gas depletion deductions, and certain distributions) for the taxable year. These restoration rules apply only to indebtedness held by a shareholder as of the beginning of the taxable year in which the net increase arises. The reduction in basis of indebtedness must be restored before any net increase is applied to restore the basis of a shareholder's stock in an S corporation. In no event may the shareholder's basis of indebtedness be restored above the adjusted basis of the indebtedness under section 1016(a), excluding any adjustments under section 1016(a)(17) for prior taxable years, determined as of the beginning of the taxable year in which the net increase arises.

restoration of debt basis pursuant to section 1367(b)(2)(B) and section 1.1367-2(c), Income Tax Regs., are hereinafter collectively referred to as debt basis adjustments.

In the instant case, the record reveals that the amount of the company's losses in 1997, 1998, 1999, and 2000, exceeded the amount of the company's income in each respective tax year. Consequently, pursuant to section 1.1367-2(b), Income Tax Regs., the losses reduced Messrs. Brooks's respective open account debt bases at each respective year end. Respondent does not challenge petitioners' recognition of such losses.⁸

For the purpose of determining taxable income upon an S corporation's repayment of shareholder advances, a separate transaction involving an advance and repayment of indebtedness is generally treated separately. See sec. 1.1367-2(a), (b)(3), (c)(2), Income Tax Regs. Shareholders may not offset the repayment of a shareholder advance with the basis of another separate shareholder advance. Cornelius v. Commissioner, 58 T.C. 417 (1972) (discussed further below), affd. 494 F.2d 465 (5th Cir. 1974). However, multiple shareholder advances and repayments that constitute open account indebtedness are treated

⁸Respondent concedes that the Dec. 31, 1999, open account advance provided sufficient debt basis for petitioners to recognize the losses claimed in 1999 and that the Dec. 29, 2000, advance provided sufficient debt basis for petitioners to recognize the losses claimed in 2000.

as a single indebtedness rather than separate indebtedness. See Cornelius v. Commissioner, 494 F.2d 465, 476 (5th Cir. 1974); sec. 1.1367-2(a), Income Tax Regs.⁹

Petitioners contend that the basis of a shareholder's open account debt is properly determined at the close of the S corporation's tax year by first netting advances and repayments of open account debt during the tax year and then making any necessary debt basis adjustments. Respondent relies on Cornelius v. Commissioner, 494 F.2d 465 (5th Cir. 1974), for the proposition that Messrs. Brooks must recognize income on the repayment of their advances to the extent that the repayments exceed their basis in the advance on the date of repayment, without regard to the basis of subsequent advances in the year of repayment.

We believe that respondent's reliance in the instant case on Cornelius v. Commissioner, supra, is misplaced. In Cornelius, the Fifth Circuit Court of Appeals affirmed the finding of this Court that the advances by the taxpayers to their S corporation and the repayments of those advances constituted separate and

⁹Sec. 1.1367-2(a), Income Tax Regs., provides that advances and repayments of open account debt are treated as a single indebtedness for the purpose of making debt basis adjustments and defines open account debt as "shareholder advances not evidenced by separate written instruments and repayments on the advances".

complete transactions as opposed to open account debt.¹⁰

Cornelius v. Commissioner, 494 F.2d at 471. The Court of Appeals stated:

The real question to be decided is whether each advance to the corporation by the shareholders and its corresponding repayment constitute a separate and complete transaction or whether the indebtedness should be considered as an "open account" whose fluctuations are to be measured for tax purposes at the end of each taxable year. * * * The Tax Court properly determined that "the 1966 loans and the [1967] repayments thereof constituted a completed transaction, and the loans occurring later in 1967 were separate and apart from such transaction." * * * [Id.; citation omitted.]

Based on the Tax Court's finding in Cornelius that the loans were separate transactions and not open account indebtedness, the taxpayers were required to recognize as taxable income the amount of the repayment in excess of the taxpayers' basis in the advance at the time of repayment, without regard to the basis of a subsequent advance in the year of repayment. Cornelius v. Commissioner, 58 T.C. at 423. It may be inferred that a netting of advances and repayments during the year would have been proper if the loans had been open account indebtedness rather than separate transactions.¹¹ Cornelius v. Commissioner, 494 F.2d at

¹⁰Pursuant to Bonner v. City of Prichard, 661 F.2d 1206 (11th Cir. 1981), the precedent of the Fifth Circuit Court of Appeals decided as of Sept. 30, 1981, is followed by the Eleventh Circuit Court of Appeals, the circuit to which an appeal of this case, absent stipulation to the contrary, would lie.

¹¹In Smith v. Commissioner, 48 T.C. 872 (1967), affd. in part and revd. in part on another issue 424 F.2d 219 (9th Cir. (continued...))

471. In contrast to Cornelius, the parties in the instant case have stipulated that the advances in issue constitute open account debt. Respondent has made no contention that any advance and repayment constitutes a separate indebtedness or closed transaction.

Based on the parties' stipulations that the advances were open account debt and respondent's failure to contend that any advance and repayment composed a separate transaction, we hold that the basis of the open account indebtedness is properly computed by netting at the close of the year advances of open account debt during the year and repayments of open account debt during the year. Cf. Cornelius v. Commissioner, 494 F.2d 465 (5th Cir. 1974). Consequently, the advances in 1999 and 2000 shielded petitioners from the realization of gain upon the repayments during those years.

We have considered all contentions that the parties have

¹¹(...continued)
1970), respondent did not dispute that advances and repayments of open account debt were properly netted prior to determining income on repayment. In that opinion, we stated: "The net payment' approach utilized by petitioners has not been questioned by respondent." Id. at 882 n.6.

raised.¹² To the extent not addressed herein, those contentions are without merit or unnecessary to reach.

To reflect the foregoing and concessions by the parties,

Decisions will be
entered under Rule 155.

¹²We note that the parties have argued extensively regarding the scope of sec. 1.1367-2, Income Tax Regs. Respondent contends that the open account debt rule of sec. 1.1367-2(a), Income Tax Regs., does not apply to the instant case because the shareholder advances in issue are not allowed restoration of debt basis pursuant to sec. 1.1367-2(c), Income Tax Regs. Petitioner contends that the open account debt rule of sec. 1.1367-2(a), Income Tax Regs., provides for the netting of the advances and repayments in issue at the close of the tax year for purposes of determining income on a repayment. Based on our holding above, we need not address the parties' contentions concerning sec. 1.1367-2, Income Tax Regs., and leave this issue for another day.

Appendix

I. Computation of Debt Bases

A. Respondent

With respect to the 1999 tax year, respondent's position results in (1) a debt basis of \$358,707 for petitioners in docket No. 8981-03 at the close of 1999, reflecting a reduction of basis in the \$800,000 advance only by an allowable loss of \$441,293, and (2) a debt basis of \$386,056 for petitioners in docket No. 8983-03 at the close of 1999, reflecting a reduction of basis in the \$800,000 advance only by an allowable loss of \$413,944 for petitioners' 1999 tax year.

With respect to the 2000 tax year, respondent's position results in (1) a debt basis of \$718,762 for petitioners in docket No. 8981-03 at the close of 2000, reflecting a reduction of basis in the \$1,100,000 advance only by an allowable loss of \$381,238, and (2) a debt basis of \$703,202 for petitioners in docket No. 8981-03 at the close of 2000, reflecting a reduction of basis in the \$1,100,000 advance only by an allowable loss of \$396,798.

B. Petitioners

With respect to the 1999 tax year, petitioners contend that the basis of each \$800,000 advance was first reduced by the \$500,000 repayments on January 5, 1999, and then further reduced by \$300,000 of pro rata company losses, resulting in a zero debt basis at the close of 1999.

With respect to the 2000 tax year, petitioners contend that the basis of each \$1,100,000 advance was first reduced by the \$800,000 repayments on January 3, 2000, and then further reduced by \$300,000 of pro rata company losses, resulting in a zero debt basis at the close of 2000.

II. Computation of Gain

A. Respondent

With respect to the 1999 tax year, respondent determined that (1) petitioners in docket No. 8981-03 had a taxable gain of \$500,000 related to the repayment of January 5, 1999 (\$500,000 repayment less zero debt basis), and (2) petitioners in docket No. 8983-03 had a taxable gain of \$500,000 related to the repayment of January 5, 1999 (\$500,000 repayment less zero debt basis).¹³

¹³Respondent attached to the docket No. 8981-03 statutory notice of deficiency the following calculation of taxable gain on debt repayment:

Computation of Taxable Debt Repayment

1997 loan from shareholder	500,000
Less: 1997 loss applied to basis	(195,042)
Less: 1998 loss applied to the basis	<u>(319,875)</u>
1997 loan basis	0
1999 loan repayment	<u>500,000</u>
Taxable gain on loan repayment	500,000

Respondent attached to the docket No. 8983-03 statutory notice of deficiency the following calculation of taxable gain on debt repayment:

Computation of Taxable Debt Repayment

(continued...)

With respect to the 2000 tax year, respondent determined that petitioners in docket No. 8981-03 had a taxable gain of \$441,293 related to the repayment of January 3, 2000 (\$800,000 repayment less \$358,707 debt basis), and that petitioners in docket No. 8983-03 had a taxable gain of \$413,944 related to the repayment of January 3, 2000 (\$800,000 repayment less \$386,056 debt basis).¹⁴

B. Petitioners

With respect to the 1999 tax year, petitioners contend that the \$800,000 basis of each advance offset the \$500,000 repayments

¹³ (...continued)	
1997 loan from shareholder	500,000
Less: 1997 loss applied to basis	(203,002)
Less: 1998 loss applied to the basis	<u>(296,998)</u>
1997 loan basis	0
1999 loan repayment	<u>500,000</u>
Taxable gain on loan repayment	500,000

¹⁴Respondent attached to the docket No. 8981-03 statutory notice of deficiency the following calculation of taxable gain on debt repayment:

"1999" loan from shareholder	800,000
Less: 1999 loss used against loan	<u>(441,293)</u>
Basis of 1999 loan	358,707
Repayment of loan made in 2000	<u>800,000</u>
Taxable gain on loan repayment	441,293

Respondent attached to the docket No. 8983-03 statutory notice of deficiency the following calculation of taxable gain on debt repayment:

"1999" loan from shareholder	800,000
Less: 1999 loss used against loan	<u>(413,944)</u>
Basis of 1999 loan	386,056
Repayment of loan made in 2000	<u>800,000</u>
Taxable gain on loan repayment	413,944

on January 5, 1999, and also allowed for the recognition of \$300,000 of the pro rata share of the company's losses.

With respect to the 2000 tax year, petitioners contend that the \$1,100,000 basis of each advance offset the \$800,000 repayments on January 3, 2000, and also permitted each petitioner to recognize \$300,000 of the pro rata share of the company's losses.

**CORNELIUS, ET AL. v. COMM., Cite as 33 AFTR 2d 74-1331,
05/16/1974**

Paul G. CORNELIUS, ET AL., (Mary M. Cornelius as Executrix of the Estate of Paul G. Cornelius, Deceased, substituted instead of and in place of Paul G. Cornelius), PETITIONERS-APPELLANTS v. COMMISSIONER of Internal Revenue, RESPONDENT-APPELLEE.

Case Information:

Code Sec(s):	
Court Name:	U.S. Court of Appeals, Fifth Circuit,
Docket No.:	No. 73-1005,
Date Decided:	05/16/1974
Prior History:	58 TC 417. (Opinion by Quealy, <i>J.</i>) affirmed.
Tax Year(s):	Year 1967.
Disposition:	Decision for Govt.
Cites:	33 AFTR 2d 74-1331, 494 F2d 465, 74-1 USTC P 9446.

HEADNOTE

1. SUBCHAPTER S ELECTION—Basis—corporate payment of indebtedness.

Repayment resulted in ordinary income to extent face amount exceeded shareholders' basis in loans where debt basis of Subchapter S corp. had been reduced under Sec. 1376 (b). Further, corp. treated advances as loans instead of capital contributions; shareholders couldn't now argue in favor of latter after discovering adverse tax consequences resulting from loan. And, each advance and repayment was separate and complete transaction, as opposed to open account whose fluctuation would be measured at end of tax year.

Reference(s): 1974 P-H Fed. ¶33,448(10).

OPINION

Martin J. Nash, Miami, Fla., Vernon Turner, Homestead, Fla., Attys. for Appellants.

Scott P. Crampton, Asst. Atty. Gen., Meyer Rothwacks, Leonard J. Henzke, Jr., Murray S. Horwitz, Attys., Tax Div., Dept. of Justice, Wash., D.C., for Appellee.

Appeals from a Decision of the Tax Court of the United States (Florida Case).

Before TUTTLE, BELL and GOLDBERG, Circuit Judges.

Judge: GOLDBERG, Circuit Judge:

[1] Appellant taxpayers, Paul G. Cornelius, Sr. and his wife Mary M. Cornelius, and Jack H. Cornelius (a son of Paul G. Cornelius, Sr.) and his wife Betty J. Cornelius, appeal from a decision of the United States Tax Court declaring that taxpayers were deficient [pg. 74-1332] in their income tax payments for taxable year 1967 in the amounts of \$59,525.71 and \$27,877.72, respectively.¹ This Court has jurisdiction to hear the appeal under Int.Rev. Code of 1954, §7482.

From 1960 through July of 1966, Paul Cornelius, Sr., and Jack Cornelius conducted a farming operation as partners under the name Cornelius and Sons. The elder Cornelius had a two-thirds interest in the partnership, and his son had the remaining one-third interest. On July 29, 1966, Paul, Mary, and Jack Cornelius formed a Florida corporation entitled Cornelius and Sons, Inc., which assumed the farming operations of the partnership. The stock records reflect that 9000 shares were issued, with 5999 shares going to Paul Cornelius, one share to Mary Cornelius, and 3000 shares to Jack Cornelius. On August 4, 1966, Cornelius and Sons, Inc. elected to be taxed as a small business corporation under the provisions of Subchapter S of the Internal Revenue Code.²

Upon forming the corporation, taxpayers transferred to it partnership assets having a basis of \$102,000. These assets, which included tractors and implements used in the process of farming, cash, and prepaid land rents, were credited to capital stock and paid-in surplus as follows:

Shareholders	Capital Stock	Paid-in Surplus	Total
Paul Cornelius	\$5,999	\$62,000	\$ 67,999
Mary Cornelius	1	-	1
Jack Cornelius	3,000	31,000	34,000
	-----	-----	-----
Total--Paul, Mary, Jack	\$9,000	\$93,000	\$102,000

The vegetable farming operation conducted by the corporation, as by the partnership which preceded it, consisted of growing and harvesting pole beans, yellow squash, and

tomatoes, and was of a highly seasonal nature. Substantial funds were required in the fall of each year in order to meet planting expenditures. In the fall of 1966 taxpayers advanced \$215,000 to the corporation in the following proportions: Paul Cornelius, \$130,000; Mary Cornelius, \$20,000; Jack Cornelius, \$65,000. These advances, a continuation of the practice initiated by the partnership for financing the fall crop, were borrowed by the shareholders from a bank. Although the advances were reflected on the corporation records as "notes payable," no notes were actually given for such advances.

In its first short taxable year of operation, which ended December 31, 1966, the corporation incurred a net operating loss of \$245,985.97. In accordance with the provisions of section 1374,³ Paul and Mary Cornelius claimed a deduction of \$163,990.65 on their 1966 joint income tax returns, representing their allocable share of the net operating loss of the corporation; correspondingly, Jack Cornelius claimed a deduction of \$81,995.32 as his allocable share of the loss. As a consequence of the net operating loss and accompanying deductions, the basis for each of taxpayers' stock accounts was reduced to zero and the basis for each of their debt accounts was partially reduced, pursuant to section 1376(b).⁴ The result, as reflected [pg. 74-1333] in the following table, was an aggregate reduction in basis for stock of \$102,000.00 and an aggregate reduction in basis for indebtedness of \$143,985.97:⁵

Taxpayer	Beginning Basis	Sec. 1376 (b) Adjustment	Ending Basis
Paul Cornelius			
Stock	\$ 67,999.00	\$ 67,999.00	-
Debt	130,000.00	95,964.31	\$34,035.69
Mary Cornelius			
Stock	1.00	1.00	-
Debt	20,000.00	26.34	19,973.66
Jack Cornelius			
Stock	34,000.00	34,000.00	-
Debt	65,000.00	47,995.32	17,004.68
Total			
Stock	\$102,000.00	\$102,000.00	-
Debt	\$215,000.00	\$143,985.97	\$71,014.03

In the spring of 1967, continuing a practice followed by the predecessor partnership, the corporation repaid the \$215,000.00 advanced by taxpayers the previous fall. In the fall of 1967, Paul Cornelius and Jack Cornelius advanced \$175,000.00—\$116,667.00 and \$58,333.00, respectively—to the corporation to finance the fall crop.

Taxpayers treated the spring 1967 repayment and the fall 1967 advance as investment transactions. The Commissioner, however, determined that the \$215,000.00 repayment in the spring of 1967 constituted repayment of loans and thus represented gain to the extent that the repayments exceeded the loan bases which had been lowered as a result of the loss pass-through in 1966. According to the Commissioner's ruling, taxpayers would have additional ordinary income of \$143,985.97,⁶ yielding an additional tax of \$89,014.58. The Tax Court sustained the Commissioner's determination.

On this appeal taxpayers argue primarily that loans whose bases have been reduced by corporate losses should be treated together with stock as a composite "investment by a stockholder" for purposes of Subchapter S, so that the bases will be increased when undistributed profits are earned in subsequent years. Alternatively, taxpayers argue that the Tax Court erred in determining that the advances made to the corporation constituted debt rather than equity. Taxpayers make the further alternative argument that the 1967 repayments and readvances should have been netted before any tax incidence was determined. We find taxpayers' contentions provocative and imaginative, but in the final analysis unpersuasive, and we affirm. [pg. 74-1334]

Subchapter S of the Internal Revenue Code was enacted in 1958 in response to recommendations over a number of years by a variety of individuals and groups—from entrepreneurs to tax lawyers to the President of the United States—that small businesses be enabled "to operate under whatever form of organization is desirable for their particular circumstances, without incurring unnecessary tax penalties."⁷ Most of the reformers suggested that closely held corporations be given the option to be taxed as partnerships. Congress chose instead, however, to create an entirely new statutory superstructure, many of whose potential perquisites and pitfalls have yet to be fully explored. On this appeal our duty is not to map all of the remaining uncharted territory, but to shape the juridical sinuosities of Subchapter S to the narrow problem before us—the interrelated tax effect of a small business corporation's net operating loss and its repayment of shareholder loans.

Although Congress chose not to permit small business corporations to opt for partnership taxation as such, it did through Subchapter S create a system for relieving closely held corporations of federal income tax burdens while passing corporate profits and losses through to shareholders in a manner similar to a partnership.⁸ The basis of a shareholder's stock is increased for amounts treated as dividends; and the bases of his stock and of corporate indebtedness are reduced for his portion of the corporation's net operating loss.⁹ In the case sub judice the corporation sustained substantial losses in the same taxable year (1966) that taxpayers had made sizeable loans to the corporation. Because of the basis of indebtedness created by the loans, taxpayers were able to offset all of the corporation's net operating losses against ordinary income. Those losses, however, reduced taxpayers' bases in their loans to the corporation; repayment of the loans in the spring of 1967 thus substantially exceeded taxpayers' adjusted bases. Under general tax principles a loan repayment to a taxpayer constitutes income to the extent the repayment exceeds the taxpayer's basis in the loan. Unless the loan is evidenced by "bonds, debentures, notes, or certificates or other evidences of indebtedness,"¹⁰ such income is taxed at ordinary rates.

Taxpayers in the present case argue that the theory of the Subchapter S election is to permit small businesses to elect a form of doing business without regard to the tax consequences of the selection of that form. In accord with that theory taxpayers contend that

it is the legislative intent ... to treat indebtedness and stock as a composite "investment by a stockholder" and to impose the same tax consequences regardless of the classification of the subsequent distribution to shareholders. (Brief for Appellants at p. 7).

Application of that analysis to the facts of this case would result in very limited tax liability upon return to taxpayers of the \$215,000.00 in advances. As under the Commissioner's determination, undistributed profits and earnings of the corporation in taxable year 1967 would be passed through to taxpayers and included in their gross income, and the basis of their stock in the corporation would be increased by that amount. According to the analysis proposed by taxpayers, however, the \$215,000.00 repayment would be a return of capital and would be taxed only to the extent it exceeded the increased basis in stock. Taxpayers argue that any other result would be illogical and inequitable.

Though we could discuss at great length the relative merits and equities of the competing approaches urged upon us by taxpayers and the Commissioner, we must be mindful that, in cases of statutory construction and legislative intent, "[i]t is our judicial function to apply statutes on the basis of what Congress [pg. 74-1335] has written, not what Congress might have written." *United States v. Great Northern Railway Co.*, 1952, 343 U.S. 562, 575, 72 S.Ct. 985, 993, 96 L.Ed. 1142. In section 1376 of the Code, which governs basis adjustments resulting from Subchapter S distributions, Congress clearly differentiated between "stock" and "indebtedness." Section 1376(a) provides for increases in the basis of "stock" alone, but section 1376(b) requires basis reductions in both "stock" and "indebtedness." We find nothing in the regulations or in the legislative history to indicate that the plain words of this section yield a distorted view of statutory intent. To the contrary, we can approach 20-20 vision of the statutory meaning through historical hindsight. As early as 1959 the American Bar Association Taxation Committee recommended that section 1376(a) be amended so that undistributed income of a corporation would first increase the basis of the shareholder's indebtedness which had been lowered as a result of net operating losses, and after the basis of indebtedness had been fully restored, would increase the shareholder's basis of stock. 1959 ABA Section of Taxation, Program and Committee Reports 90. The Treasury Department made the same proposal in preparation for the Tax Reform Act of 1969. 2 U.S. Treasury Department, Tax Reform Studies and Proposals 287, 288 (Comm.Print 1969, 91st Cong., 1st Sess., House Committee on Ways and Means and Senate Committee on Finance). The proposal was never enacted. This Court will not grant to taxpayers by judicial interpretation what Congress refused to authorize by legislation at the beseeching of such notable tax cognoscenti.

We note that although there has not been a plethora of litigation on this issue, we are not entirely without Circuit precedent to guide our way. In *Smith v. Commissioner of Internal Revenue*, 9 Cir. 1970, 424 F.2d 219 [25 AFTR 2d 70-936], the Ninth Circuit adopted the opinion of the Tax Court, 1967, 48 T.C. 872, 878-879, on the question of the tax

consequences to shareholders in a Subchapter S corporation where, as here, payments were received by them from the corporation in reduction of a valid indebtedness. The Tax Court in Smith reconciled the principles of section 1376 with the general rule concerning repayment of indebtedness:

The general rule, as stated in *Darby Investment Corporation*, 37 T.C. 839 (1962), affirmed per curiam 315 F.2d 551 (C.A.6, 1963), for payments on a debt where the face amount of the debt is in excess of its basis, is that the payments thereon each include income in proportion to a fraction, the numerator of which is the difference between the face amount and the basis of the debt and the denominator of which is the face amount of the debt

Petitioners ... contend that the general rule, stated above, is inapplicable to the case at bar. They point out that the authorities cited dealt with a debt which was evidenced by a note, bond, or contract and which had been acquired at a discount. In the case at bar there was no evidence of indebtedness, and the difference between the basis and the face value of the debt was the result not of a discount purchase but of basis adjustments pursuant to section 1376(b)(2). Though we agree with petitioners that these differences exist, as they affect the application of this rationale to the case at bar, we are of the opinion that they are differences without distinction.

48 T.C. 879.

In the case sub judice taxpayers concede that, unless this Court rejects the reasoning in *Smith*, their argument must fail. Our interpretation of the provisions of Subchapter S and of Congressional rejection of attempts to alter it does not conflict with the analysis of the Tax Court as approved by the Ninth Circuit, and we follow its jurisprudential path.

[2] Alternatively, taxpayers argue that, even if indebtedness and stock are not entitled to the same tax treatment, the Tax Court erred in determining that the payments in question here constituted debt rather than equity. The thrust of taxpayers' complaint is that the Tax Court relied on the single factor that taxpayers had reported their advances to the corporation as "loans from shareholders" on their corporate income tax return. They contend that numerous other factors, which should have been considered, support the conclusion that the advances constituted equity rather than debt. We do not agree.

This Court has never hesitated to pierce the paper armor of a taxpayer's characterization of a particular transaction in order to reach its true substance. As appellants note, we have

done so in situations similar to this one to determine whether shareholder advances to a closely held corporation are to be considered as debts or as contributions to capital. *Berkowitz v. United States*, 5 Cir. 1969, 411 F.2d 818, 820 [23 AFTR 2d 69-1582]; *Montclair, Inc. v. Commissioner of Internal Revenue*, 5 Cir. 1963, 318 F.2d 38, 40 [11 AFTR 2d 1523]. In each such instance, however, we have done so at the request of the Commissioner to prevent a taxpayer [pg. 74-1336] from unjustifiably using his own forms and labels as a shield from the incidence of taxation. A taxpayer's attempt to pierce his own armor does not merit the same consideration. In the present case the Tax Court properly held that "[a] taxpayer cannot elect a specific course of action and then when finding himself in an adverse situation extricate himself by applying the age-old theory of substance over form." 58 T.C. 417, 422, *quoting* *A. W. Legg*, 1971, 57 T.C. 164, 169. The Tax Court's holding is in complete accord with the teaching of this Court that "although a taxpayer's own documents are not conclusive, they normally override any conflicting subjective considerations advanced by that taxpayer." *Redwing Carriers, Inc. v. Tomlinson*, 5 Cir. 1968, 399 F.2d 652, 659 n. 9 [22 AFTR 2d 5448] *interpreting* *Carlton v. United States*, 5 Cir. 1967, 385 F.2d 238 [20 AFTR 2d 5376].

This is not to say that a taxpayer may be unfairly and unalterably bound to his own inadvertent error in making a bookkeeping entry. But that is not the situation here. The Tax Court noted that the practice of making temporary loans to the business in the fall with repayment in the spring had been followed for many years. The trial court further observed that the bank was, in fact, the real lender. We are satisfied that the Tax Court correctly determined the payments in question to be debt rather than equity.

[3] Taxpayers argue finally that, even if the Commissioner should prevail on the first two issues, the Tax Court committed reversible error because it declined to treat each of the loan transactions as part of an "open account" by netting advances and readvances and determining the tax consequences as of the end of the taxable year 1967. In their view a tax of some \$87,000 has been harshly and unreasonably imposed on a \$32,000 net reduction in taxpayers' notes payable account.

The real question to be decided is whether each advance to the corporation by the shareholders and its corresponding repayment constitute a separate and complete transaction or whether the indebtedness should be considered as an "open account" whose fluctuations are to be measured for tax purposes at the end of each taxable year. Taxpayers argue that the latter formulation poses the true economic situation because: 1) the notes payable account has shown substantial balances at the end of every year the business has been in operation and is likely to do so as long as the business continues; and 2) taxpayers have experienced relatively little actual economic change from year to year. These factors, however, are not and should not be determinative. The Tax Court properly determined that "the 1966 loans and the [1967] repayments thereof constituted a completed transaction, and the loans occurring later in 1967 were separate and apart from such transaction." 58 T.C. at 423. The fact that these shareholders made loans to their corporation each fall and that the loans were repaid in full each spring, bringing the

balance in the notes payable account to zero, strongly supports the Tax Court's finding that the loans were not part of an "open account." We concur in that finding.

We are not entirely unsympathetic to taxpayers' lament that Subchapter S has been a stern tax master. Taxpayers may have suffered substantially less immediate tax liability had they continued to operate their farming business as a partnership rather than as a Subchapter S corporation. On the other hand, taxpayers fared at least as well under Subchapter S as they would have by conducting their operations in the form of a non-electing corporation. It should be noted that thousands of business enterprises choose corporate status over partnership status for a variety of reasons going beyond the subchapters and subsections of the Internal Revenue Code.

Tax sophisticates and commentators have praised the purposes of Subchapter S but have deplored its techniques. Its provisions are said to be

complex, imposing an additional stress on a tax system which is already overburdened with miniscule complexity, and disturbing the balanced operation of that system by setting hidden pitfalls for the unwary taxpayer and unjustifiable rewards for the manipulating taxpayer. Instead of accomplishing its purpose of permitting the entrepreneur to select his business form in accordance with business considerations and without regard to the tax consequences of that form, just the opposite result is accentuated by Subchapter S, in providing a third set of tax consequences.

7 J. Mertens, *Law of Federal Income Taxation* §41 B.44 (1967). These criticisms, however, are properly addressed to the Congress and not to the courts. Ours has been the more mundane assignment of contouring the codified curlicues of Subchapter S to the Code's synoptic minutiae. Being mere mortals unendowed with cosmic tax wisdom, we have performed our task as well as our fallible mentalities and compositions will permit. In so doing we have detected no fatal flaw in the Tax Court's decision. Affirmed.

¹

The Tax Court opinion is reported at 58 T.C. 417 (1972).

²

Int.Rev.Code of 1954, §§1371-1379.

³

Int.Rev.Code of 1954, §1374. Corporation net operating loss allowed to shareholders.
((a)) General rule.—A net operating loss of an electing small business corporation for any taxable year shall be allowed as a deduction from gross income of the shareholders of such corporation in the manner and to the extent set forth in this section.

(c) Determination of shareholder's portion. — (2) Limitation.—A shareholder's portion of the net operating loss of an electing small business corporation for any taxable year shall not exceed the sum of—

((A)) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of the shareholder's stock in the electing small business corporation, determined as of the close of the taxable year of the corporation ..., and

((B)) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) or any indebtedness of the corporation to the shareholder, determined as of the close of the taxable year of the corporation ...

4

Int.Rev.Code of 1954, §1376. Adjustment to basis of stock of, and indebtedness owing, shareholders.

(b) Reduction in basis of stock and indebtedness for shareholder's portion of corporation net operating loss.—

((1)) Reduction in basis of stock.—The basis of a shareholder's stock in an electing small business corporation shall be reduced (but not below zero) by an amount equal to the amount of his portion of the corporation's net operating loss for any taxable year attributable to such stock (as determined under section 1374(c)).

((2)) Reduction in basis of indebtedness.—The basis of any indebtedness of an electing small business corporation to a shareholder of such corporation shall be reduced (but not below zero) by an amount equal to the amount of the shareholder's portion of the corporation's net operating loss for any taxable year (as determined under section 1374(c)), but only to the extent that such amount exceeds the adjusted basis of the stock of such corporation held by the shareholder.

5

The share of the net operating loss allocable to each taxpayer exceeded his beginning stock basis; therefore, each was required under §1376(b)(1) to reduce his basis to zero, i.e., an aggregate of \$102,000 (the total of the assets transferred to the corporation by the shareholders/taxpayers in 1966). The reduction of \$143,995.97 in basis for indebtedness represents the amount by which the net operating loss in 1966 exceeded the adjusted basis of the stock held by the shareholders (\$245,985.97 – \$102,000.00 = \$143,985.97).

6

This figure represents the proportion of the \$215,000.00 1967 repayment of loans denoted by a fraction, the numerator of which is the amount by which the face amount of the debt (\$215,000.00) exceeds the basis of the debt after the section 1376(b) adjustment for 1966 operating losses (\$71,014.03), and the denominator of which is the face amount of the debt (\$215,000.00).

$$\left[\frac{\$215,000.00 - 71,014.03}{\$215,000.00} \right] \times \$215,000.00 = \$143,985.97].$$
 See Joe M.

Smith, 1967, 48 T.C. 872, 879, aff'd, 9 Cir. 1970, 424 F. 2d 219 [25 AFTR 2d 70-936]; Darby Investment Corp., 1962, 37 T.C. 839, aff'd, 6 Cir. 1963, 315 F. 2d 551 [11 AFTR 2d 1242].

[7](#)

President Eisenhower's Budget Message to the Eighty-Third Congress, Tax Recommendation # 16, January 1953.

[8](#)

Int.Rev.Code of 1954, §1373. Corporation undistributed taxable income taxed to shareholders.

((a)) General rule.—The undistributed taxable income of an electing small business corporation for any taxable year shall be included in the gross income of the shareholders of such corporation in the manner and to the extent set forth in this section.

((b)) Amount included in gross income.—Each person who is a shareholder of an electing small business corporation on the last day of a taxable year of such corporation shall include in his gross income, for his taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend, if on such last day there had been distributed pro rata to its shareholders by such corporation an amount equal to the corporation's undistributed taxable income for the corporation's taxable year. For purposes of this chapter, the amount so included shall be treated as an amount distributed as a dividend on the last day of the taxable year of the corporation.

For treatment of net operating losses see Int.Rev.Code of 1954, §1374, supra note 3.

[9](#)

Int.Rev.Code of 1954, §1376. See note 4, supra.

[10](#)

Int.Rev.Code of 1954, §1232.

Document Title: CORNELIUS, ET AL. v. COMM., 33 AFTR 2d 74-1331, (CA5), 05/16/1974

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Federal Regulations

Reg § 1.1367-2. Adjustments to basis of indebtedness to shareholder.

(a) In general. This section provides rules relating to adjustments required by subchapter S to the basis of indebtedness of an S corporation to a shareholder. For purposes of this section, shareholder advances not evidenced by separate written instruments and repayments on the advances (*OPEN ACCOUNT DEBT*) are treated as a single indebtedness. The basis of indebtedness of the S corporation to a shareholder is reduced as provided in paragraph (b) of this section and restored as provided in paragraph (c) of this section.

(b) Reduction in basis of indebtedness.

(1) General rule. If, after making the adjustments required by section 1367 (a)(1) for any taxable year of the S corporation, the amounts specified in section 1367(a)(2)(B), (C), (D), and (E) (relating to losses, deductions, noncapital, nondeductible expenses, and certain oil and gas depletion deductions) exceed the basis of a shareholder's stock in the corporation, the excess is applied to reduce (but not below zero) the basis of any indebtedness of the S corporation to the shareholder held by the shareholder at the close of the corporation's taxable year. Any such indebtedness that has been satisfied by the corporation, or disposed of or forgiven by the shareholder, during the taxable year, is not held by the shareholder at the close of that year and is not subject to basis reduction.

(2) Termination of shareholder's interest in corporation during taxable year. If a shareholder terminates his or her interest in the corporation during the taxable year, the rules of this paragraph (b) are applied with respect to any indebtedness of the S corporation held by the shareholder immediately prior to the termination of the shareholder's interest in the corporation.

(3) Multiple indebtedness. If a shareholder holds more than one indebtedness at the close of the corporation's taxable year or, if applicable, immediately prior to the termination of the shareholder's interest in the corporation, the reduction in basis is applied to each indebtedness in the same proportion that the basis of each indebtedness bears to the aggregate bases of the indebtedness to the shareholder.

(c) Restoration of basis.

(1) General rule. If, for any taxable year of an S corporation beginning after December 31, 1982, there has been a reduction in the basis of an indebtedness of the S corporation to a shareholder under section 1367(b)(2)(A), any net increase in any subsequent taxable year of the corporation is applied to restore that reduction. For purposes of this section, net increase with respect to a shareholder means the amount by which the shareholder's pro rata share of the items described in section 1367(a)(1) (relating to income items and excess deduction for depletion) exceed the items described in section 1367(a)(2) (relating to losses, deductions, noncapital, nondeductible expenses, certain oil and gas depletion deductions, and certain distributions) for the taxable year. These restoration rules apply only to indebtedness held by a shareholder as of the beginning of the taxable year in which the net increase arises. The reduction in basis of indebtedness must be restored before any net increase is applied to restore the basis of a shareholder's stock in an S corporation. In no event may the shareholder's basis of indebtedness be restored above the adjusted basis of the indebtedness under section 1016(a), excluding any adjustments under section 1016(a)(17) for prior taxable years, determined as of the beginning of the taxable year in which the net increase arises.

(2) Multiple indebtedness. If a shareholder holds more than one indebtedness as of the beginning of a corporation's taxable year, any net increase is applied first to restore the reduction of basis in any indebtedness repaid (in whole or in part) in that taxable year to the extent necessary to offset any gain that would otherwise be realized on the repayment. Any remaining net increase is applied to restore each outstanding indebtedness in proportion to the amount that the basis of each outstanding indebtedness has been reduced under section 1367(b)(2)(A) and paragraph (b) of this section and not restored under section 1367(b)(2)(B) and this paragraph (c).

(d) Time at which adjustments to basis of indebtedness are effective.

(1) In general. The amounts of the adjustments to basis of indebtedness provided in section 1367(b)(2) and this section are determined as of the close of the corporation's taxable year, and the adjustments are generally effective as of the close of the corporation's taxable year. However, if the shareholder is not a shareholder in the corporation at that time, these adjustments are effective immediately before the shareholder terminates his or her interest in the corporation. If a debt is disposed of or repaid in

whole or in part before the close of the taxable year, the basis of that indebtedness is restored under paragraph (c) of this section, effective immediately before the disposition or the first repayment on the debt during the taxable year.

(2) Effect of election under section 1377(a)(2) or §1.1368-1(g)(2). If an election is made under section 1377(a)(2) (to terminate the year in the case of the termination of a shareholder's interest) or under §1.1368-1(g)(2) (to terminate the year in the case of a qualifying disposition), this paragraph (d) applies as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which the shareholder either terminates his or her interest in the corporation or disposes of a substantial amount of stock, whichever the case may be.

(e) Examples. The following examples illustrate the principles of §1.1367-2. In each example, the corporation is a calendar year S corporation. The lending transactions described in the examples do not result in foregone interest (within the meaning of section 7872(e)(2)), original issue discount (within the meaning of section 1273), or total unstated interest (within the meaning of section 483(b)).

Example (1). Reduction in basis of indebtedness.

(i) A has been the sole shareholder in Corporation S since 1992. In 1993, A loans S \$1,000 (Debt No. 1), which is evidenced by a ten-year promissory note in the face amount of \$1,000. In 1996, A loans S \$5,000 (Debt No. 2), which is evidenced by a demand promissory note. On December 31, 1996, the basis of A's stock is zero; the basis of Debt No. 1 has been reduced under paragraph (b) of this section to \$0; and the basis of Debt No. 2 has been reduced to \$1,000. On January 1, 1997, A loans S \$4,000 (Debt No. 3), which is evidenced by a demand promissory note. For S's 1997 taxable year, the sum of the amounts specified in section 1367(a)(1) (in this case, nonseparately computed income and the excess deduction for depletion) is \$6,000, and the sum of the amounts specified in section 1367(a)(2)(B), (D) and (E) (in this case, items of separately stated deductions and losses, noncapital, nondeductible expenses, and certain oil and gas depletion deductions—there is no nonseparately computed loss) is \$10,000. Corporation S makes no payments to A on any of the loans during 1997.

(ii) The \$4,000 excess of loss and deduction items is applied to reduce the basis of each indebtedness in proportion to the basis of that indebtedness over the aggregate bases of the indebtedness to the shareholder (determined immediately before any adjustment under section 1367(b)(2)(A) and paragraph (b) of this section is effective for the taxable year). Thus, the basis of Debt No. 2 is reduced

in an amount equal to \$800 ($\$4,000$ (excess) \times $\$1,000$ (basis of Debt No. 2) / $\$5,000$ (total basis of all debt)). Similarly, the basis in Debt No. 3 is reduced in an amount equal to $\$3,200$ ($\$4,000 \times \$4,000/\$5,000$). Accordingly, on December 31, 1997, A's basis in his stock is zero and his bases in the three debts are as follows:

12/31/97	1/1/98	1/1/96	12/31/96	1/1/97	
Debt reduction	basis	basis	reduction	basis	
No. 1.....		\$1,000	\$ 1,000	\$ 0	\$
0	\$ 0				
No. 2.....		5,000	4,000	1,000	
800	200				
No. 3.....				4,000	
3,200	800				

Example (2). Restoration of basis of indebtedness.

(i) The facts are the same as in Example 1. On July 1, 1998, S completely repays Debt No. 3, and, for S's 1998 taxable year, the net increase (within the meaning of paragraph (c) of this section) with respect to A equals \$4,500.

(ii) The net increase is applied first to restore the bases in the debts held on January 1, 1998, before any of the net increase is applied to increase A's basis in his shares of S stock. The net increase is applied to restore first the reduction of basis in indebtedness repaid in 1998. Any remaining net increase is applied to restore the bases of the outstanding debts in proportion to the amount that each of these outstanding debts have been reduced previously under paragraph (b) of this section and have not been restored. As of December 31, 1998, the total reduction in A's debts held on January 1, 1998 equals \$9,000. Thus, the basis of Debt No. 3 is restored by \$3,200 (the amount of the previous reduction) to \$4,000. A's basis in Debt No. 3 is treated as restored immediately before that debt is repaid. Accordingly, A does not realize any gain on the repayment. The remaining net increase of \$1,300 ($\$4,500 - \$3,200$) is applied to restore the bases of Debt No. 1 and Debt No. 2. As of December 31, 1998, the total reduction in these outstanding debts is \$5,800 ($\$9,000 - \$3,200$). The basis of Debt No. 1 is restored in an amount equal to \$224 ($\$1,300 \times \$1,000/\$5,800$). Similarly, the basis in Debt No. 2 is restored in an amount equal to \$1,076 ($\$1,300 \times \$4,800/\$5,800$). On December 31, 1998, A's basis in his S stock is zero and his bases in the two remaining debts are as follows:

	Original	Amount	1/1/98	Amount	
12/31/98	basis	reduced	basis	restored	basis
	\$ 1,000	\$1,000	\$ 0	\$ 224	\$
224					
	5,000	4,800	200	1,076	
1,276					

Example (3). Full restoration of basis in indebtedness when debt is repaid in part during the taxable year.

(i) C has been a shareholder in Corporation S since 1992. In 1997, C loans S \$1,000. S issues its note to C in the amount of \$1,000, of which \$950 is payable on March 1, 1998, and \$50 is payable on March 1, 1999. On December 31, 1997, C's basis in all her shares of S stock is zero and her basis in the note has been reduced under paragraph (b) of this section to \$900. For 1998, the net increase (within the meaning of paragraph (c) of this section) with respect to C is \$300.

(ii) Because C's basis of indebtedness was reduced in a prior taxable year under §1.1367-2(b), the net increase for 1998 is applied to restore this reduction. The restored basis cannot exceed the adjusted basis of the debt as of the beginning of the first day of 1998, excluding prior adjustments under section 1367, or \$1,000. Therefore, \$100 of the \$300 net increase is applied to restore the basis of the debt from \$900 to \$1,000 effective immediately before the repayment on March 1, 1998. The remaining net increase of \$200 increases C's basis in her stock.

Example (4). Determination of net increase—Distribution in excess of increase in basis.

(i) D has been the sole shareholder in Corporation S since 1990. On January 1, 1996, D loans S \$10,000 in return for a note from S in the amount of \$10,000 of which \$5,000 is payable on each of January 1, 2000, and January 1, 2001. On December 31, 1997, the basis of D's shares of S stock is zero, and his basis in the note has been reduced under paragraph (b) of this section to \$8,000. During 1998, the sum of the items under section 1367(a)(1) (relating to increases in basis of stock) with respect to D equals \$10,000 (in this case, nonseparately computed income), and the sum of the items under section 1367(a)(2)(B), (C), (D), and (E) (relating to decreases in basis of stock) with respect to D equals \$0. During 1998, S also makes distributions to D totaling \$11,000. This distribution is an item that reduces basis of stock under section 1367(a)(2)(A) and must be taken into account

for purposes of determining whether there is a net increase for the taxable year. Thus, for 1998, there is no net increase with respect to D because the amount of the items provided in section 1367(a)(1) do not exceed the amount of the items provided in section 1367(a)(2).

(ii) Because there is no net increase with respect to D for 1998, none of the 1997 reduction in D's basis in the indebtedness is restored. The \$10,000 increase in basis under section 1367(a)(1) is applied to increase D's basis in his S stock. Under section 1367(a)(2)(A), the \$11,000 distribution with respect to D's stock reduces D's basis in his shares of S stock to \$0. See section 1368 and §1.1368-1(c) and (d) for the tax treatment of the \$1,000 distribution in excess of D's basis.

Example (5). Distributions less than increase in basis.

(i) The facts are the same as in Example 4, except that in 1998 S makes distributions to D totaling \$8,000. On these facts, for 1998, there is a net increase with respect to D of \$2,000 (the amount by which the items provided in section 1367(a)(1) exceed the amount of the items provided in section 1367(a)(2)).

(ii) Because there is a net increase of \$2,000 with respect to D for 1998, \$2,000 of the \$10,000 increase in basis under section 1367(a)(1) is first applied to restore D's basis in the indebtedness to \$10,000 (\$8,000 + \$ 2,000). Accordingly, on December 31, 1998, D has a basis in his shares of S stock of \$0 (\$0 + \$8,000 (increase in basis remaining after restoring basis in indebtedness) – \$8,000 (distribution)) and a basis in the note of \$10,000.

T.D. 8508, 12/30/93 .

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Revenue Rulings

Rev. Rul. 64-162, 1964-1 CB 304, IRC Sec(s). 1232

Headnote:

Rev. Rul. 64-162, 1964-1 CB 304 -- IRC Sec. 1232 (Also Section 1376; 1.1376-2.)

Reference(s): Code Sec. 1232; Reg § 1.1232-1

Where a shareholder-creditor of an electing small business corporation, as defined in section 1371 of the Internal Revenue Code of 1954, has reduced his basis in the corporation's note by the amount by which his share of the corporation's net operating loss sustained in a prior year exceeded his basis in the corporation's stock, the repayment of the note (exclusive of interest) is considered to be an amount received in exchange for a capital asset, where the note is a capital asset in the shareholder's hands. Installments received in retirement of the note must be allocated in part to a return of the shareholder's basis in the loan and in part to income.

Full Text:

Advice has been requested concerning the treatment, for Federal income tax purposes, of loan repayments received by a shareholder-creditor from an electing small business corporation, where the basis of the loan has been reduced by the shareholder's pro rata share of the small business corporation's net operating loss in a prior year.

On January 1, 1960, the taxpayer, a shareholder in an electing small business corporation, as defined in section 1371 of the Internal Revenue Code of 1954, loaned the corporation 10x dollars. The corporation issued its note to the taxpayer in the amount of 10x dollars, of which 3x dollars was payable on January 1, 1962, and 7x dollars was payable on January 1, 1963, with interest at the rate of six percent per annum on the unpaid balance. This note was a capital asset in the hands of the taxpayer.

For the calendar year 1961, the corporation sustained a net operating loss of 30x dollars. As one of the corporation's three shareholders, the taxpayer's pro rata share of such loss, determined in accordance with section 1374(c) of the Code, was 10x dollars. This exceeded his adjusted basis for his stock in the corporation by 6x dollars. To the extent of such excess, the taxpayer's basis in the note was reduced under section 1376(b)(2) of the Code to 4x dollars. Subsequently, the corporation made timely payments to the taxpayer on the note.

Section 1232(a)(1) of the Code provides, in pertinent part, that in the case of notes or other evidences of indebtedness which are capital assets in the hands of the taxpayer and which are issued by any corporation, amounts received by the holder on retirement of such evidences of indebtedness shall be considered as amounts received in exchange therefor.

In view of the foregoing, the amounts (exclusive of interest) received by the taxpayer on January 1, 1962, and January 1, 1963, on retirement of the note, constitute amounts received in exchange for a capital **<Page 305>** asset as defined in section 1221 of the Code. Accordingly, it is held that such amounts are gains from the sale or exchange of a capital asset to the extent that they exceed the taxpayer's basis in the note.

Each payment in retirement of the note must be allocated in part to a return of the taxpayer's basis and in part to the receipt of income. Compare *Darby Investment Corporation v. Commissioner*, 37 T.C. 839 (1962), affirmed, 315 Fed. (2d) 551 (1963). Thus, the 3x dollar payment received on January 1, 1962, must be allocated 4x/10x, or two-fifths, to the return of the taxpayer's basis and 6x/10x, or three-fifths, to income.

The interest payments will, of course, constitute ordinary income.

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Revenue Rulings

Rev. Rul. 68-537, 1968-2 CB 372, IRC Sec(s). 1376

Headnote:

Rev. Rul. 68-537, 1968-2 CB 372 -- IRC Sec. 1376

Reference(s): Code Sec. 1376; Reg § 1.1376-1

A shareholder-creditor of a small business corporation derives ordinary income from the repayment of a loan made on open account to the extent that the repayments exceed his basis in the loan.

Full Text:

An electing small business corporation, as defined in section 1371 of the Internal Revenue Code of 1954, repaid to one of its shareholders a loan made on open account. The shareholder's basis in the loan was reduced by the amount by which his share of the corporation net operating loss exceeded his basis in the corporation's stock.

Held, the installments received by the shareholder in retirement of the loan must be allocated in part to a return of his basis in the loan and in part to income, but the income is ordinary income and not income from the exchange of a capital asset. See *Joe M. Smith and Florence P. Smith et al v. Commissioner*, 48 T.C. 872 (1967).

The situation here involved is distinguishable from that in Revenue Ruling 64-162, C.B. 1964-1 (Part 1), 304, since in that Revenue Ruling the corporation had issued its shareholder a note as an evidence of the indebtedness and such note was a capital asset in the hands of the shareholder.

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